

SFC Succeeds in Obtaining Orders Requiring Hontex to Buy Back IPO Shares

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On 20 June 2012 the Court of First Instance granted orders for Fujian-based textile company Hontex International Holdings Co. ("**Hontex**") to repurchase shares from investors that subscribed for shares in Hontex's IPO or purchased them in the secondary market. The proceedings were brought by the Securities and Futures Commission ("**SFC**"), which accused Hontex of misleading investors with false and misleading information in its IPO prospectus.

Under the orders, Hontex will offer a total of HK\$1.03 billion to minority shareholders in the buyback scheme, which needs to be approved by shareholders. If approved, shareholders may accept or reject the repurchase offer.

This is the first time that the SFC has negotiated a share buyback by a listed company to compensate IPO investors. This result confirms that the SFC can successfully pursue enforcement action directly in the High Court.

SFC Proceedings

The SFC investigation concerned the flotation of Hontex on the Hong Kong Stock Exchange in December 2009. The SFC investigated claims made in the IPO prospectus, and in March 2010 suspended trading in Hontex's shares and obtained orders freezing the assets of Hontex and certain subsidiaries up to a value of HK\$997.4 million. The SFC proceedings were aimed at restoring the funds raised in the IPO to shareholders that acquired IPO shares on the primary or secondary markets.

Proceedings were brought under section 213 of the Securities and Futures Ordinance ("**Section 213**" of the "**SFO**"). Section 213 provides that the SFC may apply to the Court of First Instance for orders against a person who has contravened other provisions in the SFO or some provisions in the Companies Ordinance.

In these proceedings, the SFC sought a declaration under Section 213 that Hontex had contravened, *inter alia*, section 298 of the SFO ("**Section 298**"). Section 298 creates a market misconduct offence for the disclosure of materially false or misleading information that is likely to induce another person to subscribe for or purchase securities, if the person disclosing the information knows or is reckless as to whether the information is false or misleading.

Burden of Proof

As Section 298 is a criminal offence, a prosecution using the provision would need to be proved beyond reasonable doubt. However, in these proceedings the provision was being used as the underlying contravention in civil proceedings brought under Section 213. A key issue was therefore whether the SFC's claims were subject to the civil or criminal burden of proof.

Hontex attempted to halt the trial on the basis that the SFC was using Section 213 to avoid proving its claims under the criminal burden of proof. The SFC argued that prior criminal proceedings would have been problematic: a criminal prosecution of the directors was not possible as they are not in Hong Kong, and prosecuting Hontex for a fine would not protect investors' interests as it would decrease the amount of funds available for compensation. It therefore sought final orders under Section 213 without any prior criminal determination.

On 7 June 2012, Harris J dismissed Hontex's claim that the SFC was trying to avoid the criminal burden of proof and allowed the trial to commence, ruling that the civil burden of proof is appropriate because criminal penalties on Hontex were not being sought.

Statement of Agreed Facts

Rather than await judgment, the SFC negotiated with Hontex an agreed statement of facts on which the orders of Harris J are based. An SFC statement notes that Hontex acknowledged that it was reckless in allowing materially false and misleading information to be included in its prospectus.

The use of an underlying criminal provision to establish civil liability was again a significant issue. According to the SFC, Hontex accepted having contravened Section 298. However, this does not constitute admission of any *criminal* contravention by Hontex or its directors. Despite this, the SFC notes that the agreement does not inhibit or prevent the commencement of criminal proceedings.

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Comment

There has been much debate over whether the Court of First Instance has jurisdiction under Section 213 to make final orders in appropriate cases without a prior determination by the Market Misconduct Tribunal or criminal prosecution under the underlying provision relied upon. This issue was resolved in the SFC's favour in the Court of Appeal in February 2012 in the *Tiger Asia* case.¹ Reversing the first instance decision of Harris J, it was held that Section 213 may serve as a free-standing remedy. In cases where criminal prosecution is difficult or impossible, the Court of Appeal treated Section 213 as providing much needed ammunition to the SFC to protect investors.

The success of the SFC against Hontex is largely due to the principles established by the Court of Appeal in *Tiger Asia*. The proceedings against Hontex confirm that the SFC may obtain final orders for market misconduct under Section 213, and that the contravention of an underlying criminal provision need only be proved on the balance of probabilities.

Takeaway point

The SFC's success in securing orders for the repurchase of shares from minority shareholders demonstrates the SFC's enforcement capabilities. It further confirms that Section 213 may be used by the SFC as an expeditious means for obtaining final orders. Following this success, it is likely that an increased use of Section 213 will be employed by the SFC against other non-Hong Kong companies that are accused of engaging in market misconduct.

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¹ *Securities and Futures Commission v Tiger Asia Management LLC*, [2012] 2 HKLRD 281