The report of the Market Misconduct Tribunal into dealings in the shares of CITIC Limited (formerly known as CITIC Pacific Limited) and others on and between 7 and 12 September 2008

A report pursuant to sections 252(3)(a) and (b) of the Securities and Futures Ordinance, Cap. 571

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CHAPTER ONE

INTRODUCTION

1. The substantive enquiry in this matter ran before the Tribunal for a period of 53 days. During that time, through the witnesses, a very broad range of matters, many of considerable complexity, were explored. Almost without exception, due to the fact that the Tribunal had before it counsel of the highest calibre, all matters that fell for exploration were – directly or indirectly – relevant and of assistance to the Tribunal. The fact remains, however, that, when confronted with such a broad canvas painted over such an extended time, the danger presents itself that the essential issues falling for determination by the Tribunal may become obscured. For this reason, it is necessary at the outset to focus on the limited issues that fell for determination, contrasting those, where relevant, with the issues that did not fall for determination.

2. The Tribunal received its mandate from the Securities and Futures Commission ('the SFC') under a Notice dated 11 September 2014, that Notice being issued pursuant to section 252(2) and Schedule 9 of the Securities and Futures Ordinance ('the Ordinance'). The Notice and the accompanying synopsis are attached to this report as Annexures A and B.

CITIC and Its Sino Iron Project

3. The SFC Notice concerned a company listed on the Stock Exchange of Hong Kong in 1986: stock number 267. At all times material to the enquiry before the Tribunal, the company was called CITIC Pacific

Limited although in August 2014 it had changed its name to CITIC Limited ('CITIC').

4. CITIC was, and remains, a major conglomerate with interests in a large number of commercial ventures. The annual report for the year ended 31 December 2007 spoke of the diversity of those ventures which included aviation, telecommunications, power generation, special steel manufacturing, iron ore mining, property development and civil infrastructure. At about that time, CITIC employed over 24,000 people and had for the first time recorded a net profit of HK$11.5 billion. Its net assets were stated to be some HK$64.6 billion (with cash and bank deposits equivalent to HK$8 billion).[1]

5. At all material times, the Chairman of CITIC was Mr Yung Chi Kin ('Mr Larry Yung'), the effective founder of the Company. In his Chairman's letter contained in the 2007 annual report, Mr Larry Yung said that CITIC was at that time concentrating primarily on three core areas of business, namely, the manufacture of special steel products, iron ore mining and property development in Mainland China.

6. Concerning the manufacture of special steel products, CITIC operated three mills in the Mainland, their annual production being some 6.5 million tonnes of special steel products. These mills required a reliable source of iron ore of the appropriate quality. In order to ensure the supply, in 2006 CITIC had acquired the mining rights to two billion tonnes of magnetite iron ore with options to secure another four billion tonnes if the reserves were proved. The iron ore was located in a 'greenfield' site - one that had not been developed – in the Pilbara region of Western Australia.

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[1] Derivative financial instruments were listed as a non-current asset at a figure of HK$150 million, this valuation being separated into those instruments that qualified for hedge accounting and those that did not.

7. The project to mine and ship the iron ore – known as the 'Sino Iron Project' - constituted what was described during the enquiry as a 'challenging' undertaking even for a conglomerate the size of CITIC. It was at the time the largest magnetite iron ore project planned in Australia; technologically a state of the art operation that would include not only the necessary infrastructure for mining the iron ore and processing it but would also include extensive supporting infrastructure: a power plant, desalination plant and, in particular, port facilities that would enable the ore to be shipped to China. Ship – bulk carriers – were also built.

8. The mining rights were held by Sino Iron Holdings Pty Limited ('Sino Iron'), a wholly owned subsidiary of CITIC while the management of the project was vested in CITIC Pacific Mining Management Pty Limited ('CITIC Mining Management'), an indirect subsidiary. CITIC Mining Management set up and staffed an office in Western Australia to oversee the project.

Financing the Sino Iron Project

9. From a relatively early stage, there were mounting cost pressures on the Sino Iron Project. By the end of 2007 projected capital expenditure had increased from US$2.5 billion to US$3.5 billion. In Mr Larry Yung's letter in the 2007 annual report, the causes for these cost pressures, aside from a planned expansion in production, were summarised as being due to –

> "… industry wide cost pressures and inflation, especially in Australia; depreciation of the US dollar to the Australian dollar and to the

> renminbi; and cost pressures and inflation in China where certain supplies are sourced."

10. The project was largely financed by Mainland banks. For budget purposes, the estimated capital expenditure of the project was denominated in US dollars. However, a substantial portion of the capital expenditure required other currencies, more particularly, renminbi, euros, Swedish krona and, in greatest measure, Australian dollars.

11. In order to minimise – or 'hedge' – the foreign exchange risk associated with fluctuations in the value of these currencies against the US dollar, CITIC made use of foreign exchange forward contracts and structured forward instruments. In the 2007 annual report, when speaking of treasury policy and risk management, it was said that the CITIC Group employed a combination of financial instruments – including derivative products – to manage its exposure to fluctuations in interest and currency rates. However, it was emphasised that:

> "Derivative transactions are only used for interest rate and currency hedging purposes, speculative trading activity is prohibited."

12. As to the extent of any foreign currency risks facing CITIC, the 2007 annual report said that the Group at the end of that year was in the position of having no material currency risk arising from its operations.

13. In respect of the Sino Iron Project, the hedging activity was conducted by CITIC's Finance Department in Hong Kong. This arrangement was necessitated by the fact that in Western Australia at that time CITIC Mining Management, while it was managing the project, lacked

the necessary revenue stream or any agreements with financial institutions enabling it to enter into hedging transactions. The solution was for the Executive Committee – the ‘ExCo’ - of CITIC Mining Management to keep CITIC’s Finance Department informed of projected foreign currency outflows and for the Finance Department to determine the nature and extent of the required hedging, itself keeping CITIC’s Executive Committee informed.

14. This arrangement, however, was subject to a written agreement between CITIC and Sino Iron, the company in which the project rights were vested, in terms of which, by way of back-to-back arrangements, all liabilities and obligations arising would be borne by Sino Iron. That said, despite the back-to-back provisions, as Sino Iron was a wholly-owned subsidiary of CITIC, it followed that any materially adverse changes to Sino Iron’s financial position arising out of CITIC’s hedging transactions may, depending on its severity, have caused a material adverse change to the financial position of the CITIC Group as a whole.

15. In respect of the Sino Iron Project, there were two disciplining factors which governed CITIC’s hedging policy:

(i) As and by way of a general policy governing all projects in which there was a foreign currency requirement, CITIC hedged no more than 30% (or approximately 30%,) of any foreign currency requirements. That said, there does not appear to have been any internal directive prescribing that exact ratio.

(ii) As to a budget rate for the Sino Iron Project, in a document dated 25 June 2007 issued by CITIC Mining Management, it was stated that the budget rate of the US dollar against the Australian dollar was to be from 0.75 to 0.80. This was subject to the stated condition that the band would be monitored and revised, if necessary, from time to time. However, because of the strength of the Australian dollar in 2007, and well into 2008, the rate of 0.80 became the *de facto* rate.

16. The evidence showed that attempts persisted to achieve this rate of 0.80 despite the continuing rise of the Australian dollar. Certainly, as Mr Chang Li Hsien, Leslie ('Mr Leslie Chang'), CITIC's Chief Finance Officer and head of the Finance Department, appeared to see it, the budget parameters were effectively set in stone. In his witness statement (some 89 pages in length) dated 7 August 2015, he spoke of the difficulties facing him by reason of a failure to compromise on that budget rate. In this regard, he said that, by reason of discussions held between September 2007 and July 2008, he understood that–

> " … the CITIC Pacific Mining ExCo well knew that an adjustment was needed to the budget rate and that it had been discussed on several occasions at CITIC Pacific Mining ExCo meetings that this was too low and was unrealistic, and that the rise in the Australian dollar meant plain vanilla swap at the specified rate was not feasible. I have seen from the CITIC Pacific Mining ExCo papers that these issues were discussed multiple times, see for

example the ExCo papers dated 23 November 2007 [2] where it was acknowledged that the spot rate was US$0.94 but the hedge strategy was to secure more hedge Australian dollars at the budget rate of US$0.8 through structured derivative contracts, but the budget rate was nonetheless never revised in light of the huge difference from the Australian dollar spot rate."

17. At the end of his witness statement – under the sub-heading of 'impossible hedge parameters' – Mr Leslie Chang said that the greatest pressure was centred on the "impossible" hedging parameters that had been set for him and his staff in the Finance Department. These parameters, he said, included the Australian dollar requirement which was constantly increasing, a difficulty exacerbated by the fact that there was no certainty as to the timing and extent of the increases. He continued:

> "Further, with a rigid budget rate, and corresponding hedging policies that (to the best of my recollection) were never revised, it would have been impossible to hedge the Australian dollar and still expect certainty on the amount to be delivered and the strike price at which the Australian dollar could be bought."

18. It should be said that not all the witnesses who testified before the Tribunal were of the opinion that it had been necessary to adhere rigidly to the budget rate of 0.80. A couple were perplexed by this insistence on rigidity. In the view of the Tribunal, however, whether the strict adherence to that budget rate was at the relevant times commercially wise or unwise is not to the point. What is to the point is that Mr Leslie Chang, and those who worked with him in the Finance Department, that is, the persons responsible

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[2] The relevant part of the minutes read: "Based on forecast by major bankers … the Australian dollar should be reaching its short-term peak at around 0.94 and commonly projected trading range is 0.85 to 0.95 in the coming one year. We do not recommend locking in the Australian dollar at the current rate. However, in view of the relatively current low hedging ratio, we will continue to closely observe the market movement and situation, target to secure more hedged amount at our budget AUD/USD rate 0.80 during construction period through the employment of structured derivative contracts."

for fashioning the hedging policy, were of the view that it *was* necessary to adhere to the budget rate even though, in order to do so, it became necessary to employ high risk derivative instruments.

The Use of Target Redemption Forward Contracts

19. Hedging for the Sino Iron Project began in 2007. Initially, it was possible for those in CITIC's Finance Department in Hong Kong to use 'plain vanilla'[3] contracts. However, in light of the continuing depreciation of the US dollar to the Australian dollar (and other currencies required for the Sino Iron Project), and seeking to adhere strictly to the budget rate of 0.80, in early September 2007 the decision was made to begin hedging by way of employing derivative instruments called target redemption forward contracts ('TRF contracts'), these being contracts entered into between CITIC and various counterparty banks.

20. It was the use of TRF contracts - referred to in the market as 'accumulators' - and their dire financial consequences that was to bring CITIC to a state of crisis. An overview of their nature - using Australian dollar/US dollar contracts for illustrative purposes - must therefore be given:

(i) By way of a generic introduction, it can be said that accumulators are derivative products which enable an investor to accumulate over a stated period of time an asset (shares, bonds, foreign currency and the like) at an initially attractive – that is, discounted - price that stays constant in

[3] "Plain vanilla' signifies the standard version of a financial instrument to be contrasted with one that alters the components of a traditional financial instrument thereby resulting in a more complex security. A plain vanilla forward contract is a contract entered into with a bank for the purchase of foreign currency at a future date and at an exchange rate that is fixed at the time of signing.

exchange for the risk that, if the asset price drops, the investor is committed to continuing accumulating the asset at a price that is now above the prevailing price, and to continue doing so perhaps on a leveraged basis, that is, even though in a losing position, to continue accumulating a greater amount of the asset.

(ii) In respect of the TRF contracts entered into by CITIC with various counterparty banks, each was an agreement, usually enduring for 24 months, in terms of which the counterparty bank was obliged to deliver to CITIC pre-determined amounts of Australian dollars each month on a specified settlement date at an exchange rate – the strike rate - agreed at the time of entering into the contract.

(iii) In the event that each month on the settlement date the prevailing Australian dollar/US dollar spot rate[4] was higher than the strike rate then CITIC would make a gain. This was because it would receive the pre-determined amount of Australian dollars at the strike rate and not at the higher prevailing market rate.

(iv) To protect the counterparty bank, however, there was a pre-determined upper limit to the value of the gains that CITIC could obtain in this way. Once CITIC had obtained that maximum gain, the contract would be 'knocked out' regardless of how much longer the contract had left to run.

4 The spot rate was determined in accordance with the provisions of each contract, usually by reference to the Reserve Bank of Australia published rate given at close of business the day before delivery of funds.

(v) If, however, on the monthly settlement date the Australian dollar/US dollar spot rate was less than the strike rate then CITIC would make a loss. First, it would receive Australian dollars at the strike rate and not at the cheaper prevailing market rate; put simply, it would be paying higher than the market rate. Second, importantly, the contracts provided that in this instance CITIC would have to take a greater amount of Australian dollars, for example, two times the pre-determined amount. By this means, potential losses on the part of CITIC could be doubled (or even trebled) depending on the terms of contract.

(vi) Nor was there any ‘knock out’ provision enabling CITIC to limit the measure of its losses. In terms of the contracts, CITIC would be obliged to continue receiving the leveraged amounts of Australian dollars until the expiration of each contract - unless of course the Australian dollar regained value, placing CITIC into a position where it was again purchasing at a profit.

(vii) A defining feature of the TRF contracts, therefore, was that, while each counterparty bank had a defined loss, CITIC carried the risk of an open ended loss, that loss accumulating over the duration of a contract.

(viii) What must also be noted is that a number of TRF contracts did not have a fixed strike price but a variable strike price. This – and other variations - increased their complexity. If, in negotiating a new TRF contract, a counterparty bank had reservations as to the volatility of the relevant currencies, it could protect itself by imposing more stringent provisions, for all practical purposes, increasing CITIC's risk. For example, 'step-up' features could be included in terms of which the strike rate increased in steps over the tenure of the contract. In this regard, it is to be noted that 12 of the 16 TRF contracts that CITIC entered into between June and August 2008 contained variable strike prices; described during the hearing as "aggressive 'step up' features and provided for the delivery of *multiples* of the notional amount of Australian dollars if the spot rate fell below the strike rate."[5]

(ix) Nor was there any pre-set mechanism in terms of which CITIC could at least crystallise its losses by having the bank 'buy-out' a contract. The bank had no such obligation. This is not to say that banks never entered into 'buy-out' arrangements. If they did, however, the process was not fully transparent. Banks quoted mark-to-market[6] values for TRF contracts but in doing so used their own internal models. While objectively verifiable inputs were employed by banks, for example, interest rates for the currencies involved and historical measures of volatility, they also used

[5] See the opening submissions of the Presenting Officer, Mr Adrian Bell SC, dated 16 October 2015.

[6] 'Mark-to-market' describes the accounting method by which assets are valued at a price at which they could be traded in the market. More will be said of the concept later in this report. What is to be emphasised, however, is that a 'mark-to-market' value is a calculation given at a particular point in time and, in respect of derivative currency contracts, such values can, theoretically, change continuously depending on factors such as the exchange rate and the volatility of the currency market. It follows, of course, that a 'mark-to-market' value is only ever crystallised when the asset itself is realised.

inputs based on their own proprietary algorithms, for example, measures of future volatility. Nor were mark-to-market values calculated by the counterparty banks definitive of price. During the enquiry, the Tribunal was informed that they were often at best a starting point for negotiation. Put another way, the assessment of mark-to-market values – being based on proprietary models and not being traded on an open market - was not a precise science.

(x) The fact that invariably only the counterparty banks understood the idiosyncratic risks associated with specific TRF contracts meant that there was no ready market for TRF contracts; they were not like shares that could be sold on an exchange. In this sense, they were, as a number of witnesses said, 'illiquid instruments'.

(xi) More than that, they were bespoke instruments, each individual TRF contract having its own particular features. Fully understanding one contract, therefore, did not result in a full understanding of each and every contract.

21. As to the manner in which CITIC treated TRF contracts in its accounts, there was a policy document in existence in 2007 and 2008 – headed 'Risk Management Policies and Hedging Activities' - which made plain that CITIC only employed derivative instruments for hedging purposes, speculative trading being prohibited. The policy document warned that derivative instruments, while providing effective economic hedges, did not necessarily qualify for hedge accounting in the Hong Kong Accountancy Standards (HKAS39). Accordingly, profit and loss arising from the

derivative instruments which did not qualify for hedge accounting would be recognised in the Consolidated Profit and Loss Accounts. As to when they would qualify, the document said :

> "a derivative may qualify as a hedging instrument in a fair value hedge if the changes in its fair value are equal and opposite to that of the hedged item".

22. TRF contracts, being asymmetrical in nature (in that their gains are capped at a relatively low level while losses are almost unlimited), did not constitute effective hedging instruments for accounting purposes. The evidence shows that this was understood by those in the senior management of CITIC who were accountants by qualification or who had relevant experience.

23. As such, as they did not qualify for hedge accounting, TRF contracts were given a mark-to-market valuation at the end of each financial period. This meant that CITIC had a consequential profit and loss exposure. In the notes to the 2007 annual report, it was said that "the fair value of outstanding derivative transactions is calculated at least semi-annually based on the price quotations obtained from major financial institutions".

24. In all, CITIC entered into a total of 49 TRF contracts denominated in Australian dollars. Through until mid-2008, with the increasing value of the Australian dollar against the US dollar, all of the contracts were 'knocked out', meaning that CITIC had achieved its maximum gains under those contracts which had then been terminated by the counterparty banks.

25. That is not to say, however, that the risks inherent in these contracts were not understood. More will be said of this later in the report but, simply to illustrate the point, in the minutes of the ExCo meeting of CITIC Mining Management held on 23 January 2008 the following was said under the heading of 'hedging':

> "Action: Mr Charles Yau to advise Hong Kong [i.e. the Hong Kong Finance Department] not to use similar products as exposure is high to a low Australian dollar."

26. That said, for reasons to be touched upon later in this report, the employment of TRF contracts was not halted and in fact continued to constitute an effective hedge. In the May 2008 CITIC Mining Management ExCo report, when looking at the question of risk at that time, it was noted that there was only one contract outstanding, all the earlier ones having been knocked out (at a profit to CITIC). A graph was embedded in the report with the following commentary appearing:

> "The key point about this graph for this month is that even a 10% drop of the Australian dollar/United States dollar rate [10% was the largest drop contemplated] does not significantly affect our exposure. This is because the remaining outstanding contract has a strike price of 0.77. Effectively, this means that the Australian dollar/United States dollar exchange rate would need to fall 19% or 20% before the leverage exposure effect in the contracts would kick in. As can be seen from the potential impact of exchange rates on the Financial Model, it is critical that additional Australian dollar hedging at favourable rates is obtained. "

27. It was forecast in the report that the available Australian dollar funding for the construction of the Sino Iron Project would be completely utilised some time in the fourth quarter of 2008.

28. It was against this background that, in June, July and August 2008 CITIC entered into a further 16 TRF contracts as a hedge against the Australian dollar. It was always accepted that it was these contracts that overwhelmingly brought about the financial crisis to which reference will be made shortly. In his final submissions to the Tribunal, Mr Bell SC, the lead presenting officer for the SFC, focused almost exclusively on these 16 contracts: doing so in part, of course, for purposes of clarity.

29. When the Australian dollar first began to lose value against the US dollar at the end of July/early August 2008, Mr Leslie Chang, having previously felt strangled by the budget parameters, saw it as a good moment to enter into further hedging contracts. In this regard, in his witness statement, he said:

> "I believed and market reports supported the view that this was a correction just as the market had seen a year before, and that it was accordingly a good moment to enter into further hedge contracts (given the growing Australian dollar requirement), and to take advantage of the lower strike rates …"

30. He continued in his statement by saying that, unknown to him and everyone in the market –

> "… the global financial crisis had already rippled out and would go on to topple the Australian dollar spot rate. By the time the Australian dollar plunged - and the drop was a dramatic 37% over the

> space of just over three months - it had already become too late to unwind the contracts…"

31. The summer and autumn of 2008 was, of course, a time of great turbulence in world markets. History shows that the contagion in the United States sub-prime mortgage market which had emerged in 2007 erupted into a global economic and financial crisis in the autumn of 2008. A couple of indicators illustrate the point:

(i) on 7 September 2008, mortgage lenders, Fannie Mae and Freddie Mac - which accounted for nearly half of the outstanding mortgages in the United States - were rescued by the United States Government in one of the largest 'bail-outs' in history; and

(ii) on 15 September 2008, Lehman Brothers, a Wall Street institution, filed for bankruptcy, this being the largest bankruptcy filing in the history of the United States: involving apparently some US$639 billion.

32. Against this background of turbulence in world markets and a sudden flight to the US dollar, commencing in late July 2008 and running through until October of that year, there was an extraordinary collapse in the Australian dollar - described by a number of counsel who appeared before the Tribunal as a 'black swan' event[7]. By all measures, it was certainly an extreme event, the Australian dollar losing some 37% of its value in just over

[7] A 'black swan' event is one that deviates greatly beyond what is normally expected of a situation and is extremely difficult to predict.

three months. A Bloomberg graph, annexed to this report as Annexure C, shows the precipitous decline from the end of July to late October 2008.[8]

CITIC's Profit Warning

33. The collapse in the value of the Australian dollar meant that CITIC's outstanding Australian dollar/US dollar TRF contracts placed CITIC under a contractual obligation to purchase increasing multiples of Australian dollars – way beyond what was needed for the construction of the Sino Iron Project - at prices materiality higher than prevailing market rates.

34. On 20 October 2008, CITIC published a profit warning. In that announcement, it informed the public of the severe losses that had been sustained through its use of TRF contracts. It was said that, based on the most up-to-date valuations received from various counterparty banks, CITIC estimated that its mark-to-market loss on that date under the outstanding leveraged foreign exchange contracts (of all currencies) was HK$14.7 billion.

35. There was a seismic reaction in the stock market. CITIC shares, which had been drifting downwards during the month of October and which had closed on the last trading day before the profit warning at $14.52, closed on the first trading day after the announcement at $6.52 (a 55% fall). The day after that they closed at $4.91.

[8] The following daily spot rates of the Australian dollar to the US dollar in the period between May and October 2008 are also illustrative :

23 May:	.9613;	22 July:	.9781;	30 July:	.9471;
6 August:	.9155;	22 August:	.8736;	2 September:	.8337;
9 September:	.8139;	12 September:	.8079;	17 September:	.7934;
23 September:	.8440;	3 October:	.7791;	16 October:	.6748;
27 October:	.6058				

36. Looking to the details of the profit warning, in the announcement CITIC informed the public that its results for the financial year ending 31 December 2008 were –

> "… expected to be affected by a loss arising from certain leveraged foreign exchange contracts entered into by the Group with a view to minimising currency exposure of the Company's iron ore mining project in Australia."

37. To soften the blow, CITIC said that its liquidity would be strengthened by CITIC Group - a state-owned company in Beijing holding 29% of the Company shares - by means of a standby loan facility of US$1.5 billion.

38. The profit warning stated that the maximum amount deliverable to the Group under all of its Australian dollar leveraged foreign exchange contracts was AUD$9.44 billion, the last amounts only falling due in October 2010. In respect of the anticipated capital expenditure on the construction of the Sino Iron Project over the coming two years, that is, until its completion, the announcement estimated that it would require AUD$1.6 billion. In respect of capital expenditure, it therefore found itself over hedged by almost 6 times.

39. Losses had not only been incurred in the Australian dollar TRF contracts. In the announcement, it was said that, assessed in euros, it was estimated that a capital expenditure of €85 million would be required for the completion of the project. However, the total maximum amount deliverable in euros under dual currency TRF contracts was in excess of €160 million.

40. As to the mark-to-market loss at the date of publication of the profit warning, the announcement said:

> "Based on the valuations received on the Latest Practicable Date from the relevant counterparties to the outstanding Leveraged Foreign Exchange Contracts and [with the appropriate currency rates stated], the mark-to-market loss of the outstanding Leveraged Foreign Exchange Contracts is HK$14.7 billion (the "mark-to-market Loss")."

41. The announcement went on to say that the amount of the mark-to-market loss at the end of the financial year, that is, as at 31 December 2008, would be driven by a number of factors including the termination of any of the Leveraged Foreign Exchange Contracts, the interim fixing and delivery of foreign currencies, changes in exchange rates, interest rate differentials and volatility in the currency markets.

42. In the profit warning, CITIC gave details of attempts already made to mitigate its losses. It spoke, for example, of the fact that it had been able to terminate some of the outstanding TRF contracts. In setting out such details, the following was said:

> "*Since becoming aware of the exposure arising from these contracts on 7 September 2008,* the Company has terminated some of the then outstanding leveraged foreign exchange contracts at a loss of HK$626.6 million. In addition, the Company has bought and sold AUD foreign exchange forwards to manage its exposure on AUD which resulted in a loss of HK$128.6 million." [emphasis added]

43. What was said, therefore, was that CITIC had been aware of the exposure arising out of the various TRF contracts for a period in excess of a

month, specifically since 7 September 2008. The statement in the profit warning was, of course, a broad one, nothing being said of the *level* of exposure of which CITIC had become aware at that earlier time.

The Dah Chong Hong Circular

44. In looking back to events in September 2008, it was discovered by the SFC that on 12 September - four clear days *after* CITIC (according to its profit warning) had become aware of its exposure - it had published a circular on the Stock Exchange website concerning a 'disclosable and connected' transaction and in that circular, in addition to providing a clear and adequate explanation of the disclosable and connected transaction itself, it had provided certain details concerning its own financial and trading position at that time.

45. Specifically, in accordance with the Listing Rules, the published circular of 12 September had said that the directors of CITIC had not been aware of any material adverse change in the financial or trading position of the Group since the last audited accounts had been published, those accounts being for the financial year ending 31 December 2007.

46. If it was the fact – as asserted in the October profit warning – that CITIC had become aware of its exposure arising out of the TRF contracts on 7 September, that fact may have contradicted the assurance given in the circular published on 12 September that it was *not* aware of any material adverse change in its financial position at that time. In short, the assurance given in the circular of 12 September may have been false or misleading as to CITIC's true financial position.

47. It was this apparent contradiction that gave rise to the enquiry and at all times lay at its heart.

48. The circular published on the Stock Exchange website was published pursuant to Chapter 14A of the Listing Rules, it being a requirement that a proposed connected transaction had to be announced and, within a period of some 21 days of that announcement, a circular addressed to shareholders had to be published.

49. After the publication of an announcement of a 'disclosable and connected transaction', it was the job of CITIC's Company Secretarial Department to see to the placing of the necessary circular on the Stock Exchange website. The circular would be drafted by CITIC's solicitors, would then be considered by an independent financial house (acting as financial adviser) and would of course be considered internally before being sent to the Stock Exchange for review. The drafting of these circulars was a fairly regular matter for CITIC, a major trading conglomerate, almost one a month being published.

50. In the present instance, the announcement of the disclosable and connected transaction had been made some 21 days prior to 12 September 2008, in about mid-August. During the course of the enquiry, it was never disputed that the August announcement and the subsequent circular related to an entirely mundane transaction, one that for CITIC itself was of no real consequence. The mid-August announcement had seemingly elicited no comment or reaction of any kind.

51. The transaction announced in the mid-August announcement and detailed in the subsequent circular was one in terms of which Dah Chong

Holdings Limited ('Dah Chong Hong'), a company listed on the Stock Exchange of Hong Kong, but also a non wholly-owned subsidiary of CITIC, acting through its own subsidiaries, had entered into a sale and purchase agreement with a company called Denker Investment Limited ('Denker Investment') in terms of which it had purchased 49% of the issued share capital of a motor business called FAW Toyota 4S Company and 50% of the issued share capital of a second motor business called Lexus 4S Company, both businesses operating in Southern China, and had also taken assignment of certain shareholders loans.

52. The total consideration in terms of the sale and purchase agreement - to be funded by the internal resources of Dah Chong Hong - was HK$143,716,000. For a corporate enterprise the size of the CITIC Group this sum was of no real consequence.

53. Aside from Dah Chong Hong being a non wholly-owned subsidiary of CITIC, Denker Investment, the vendor, was itself a substantial shareholder of various subsidiaries of Dah Chong Hong. In addition, a Mr Mak Hing Lung, who had stood as guarantor for Denker Investment, was a director of certain of those subsidiaries. As such, both Denker Investment and Mr Mak were, in respect of CITIC, classified as 'connected persons'. In the result, the acquisition costs and the financial assistance costs detailed in the sale and purchase agreement – falling within the relevant percentage ratios under the Listing Rules – constituted transactions that were disclosable by CITIC pursuant to Chapter 14A of those Rules[9].

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[9] The evidence revealed that the consideration ratio, assets ratio and profits ratio calculated by CITIC in accordance with the Listing Rules were less than 1%. Only the revenue ratio was higher, calculated to be 5.3%. As a result, the transaction constituted a 'disclosable transaction'.

54. In addition to the requirement to fully explain the connected and disclosable transaction, Chapter 14A of the Listing Rules directed that details must be published concerning CITIC itself including a statement by the directors of any material adverse change in the financial or trading position of CITIC and its subsidiaries since the date to which its last published audited accounts had been made up or, if there had been no material adverse change, a statement confirming that to be the position.[10]

55. In accordance with this direction, the Dah Chong Hong circular had contained the 'no material adverse change' statement, that statement appearing in an annexure to the circular: on page 43. The statement had been drawn up by CITIC's solicitors, the wording apparently being entirely standard: wording that had been used routinely.

> "Save as disclosed in this Circular, the directors are not aware of any material adverse change in the financial or trading position of the Group [that is, CITIC and its subsidiaries] since 31 December 2007, the date to which the latest published audited accounts of the Company [that is, CITIC] were made up."[11]

56. The circular had also contained a "responsibility statement" that was worded –

> "This Circular includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Company. The Directors collectively and individually accept full

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10 The direction was made pursuant to paragraph 32 of appendix 1, Part B of chapter 14A which reads:

"A statement by the directors of any material adverse change in the financial or trading position of the group since the date to which the latest published audited accounts of the issuer have been made up, or an appropriate negative statement."

11 During the hearing of the enquiry, it was at all times the case put forward on behalf of the SFC that it was the 'financial' position of the CITIC Group that fell for determination, not the 'trading' position.

> responsibility for the accuracy of the information contained in this Circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief, there are no other facts not contained in this Circular, the omission of which would make any statement herein misleading."

57. So that readers of the circular could know the cut-off date for updating the contents of the circular, the 'latest practicable date' by which any amendments could have been made was stated in the following terms:

> "9 September 2008, being the latest practicable date prior to the printing of this Circular for the purpose of ascertaining certain information contained in this Circular."

The 'Sunday Meeting'

58. When, in the profit warning of 20 October 2008, it was said that CITIC had become aware of the exposure arising from its leveraged foreign exchange contracts – its TRF contracts - on 7 September 2008, reference was in fact being made to an urgent meeting that had taken place on that day - a Sunday - at the offices of CITIC in Hong Kong.

59. This meeting will be referred to in greater detail later in the report. At this juncture it suffices to say that, having worked over the Friday afternoon and the Saturday, Mr Leslie Chang, in a state of considerable emotional distress, had contacted Mr Fan Hung Ling, Henry ('Mr Henry Fan'), the Managing Director of CITIC, to ask to meet him urgently. He had informed Mr Henry Fan that, due to the unexpected and drastic change in the foreign currency markets, specifically the freefall in the Australian dollar and

the Euro against the US dollar, CITIC was "facing huge losses" on its outstanding TRF contracts "on a mark-to-market basis".

60. Mr Leslie Chang had met with Mr Henry Fan on the morning of Sunday, 7 September 2008, explaining to him that he (and those working with him) had prepared figures which revealed that as at 29 August 2008, as best as could be calculated on the information available, the mark-to-market loss arising from the Australian dollar/US dollar TRF contracts (with a spot rate of 0.8578) was some HK$3.119 billion. In addition, a scenario had been prepared to show the prospective losses at different spot rates [12]:

(i) at a spot rate of 0.8500 (Australian dollar/US dollar) and 1.45 (Euro/US dollar), under the outstanding Australian dollar denominated TRF contracts CITIC was looking at a mark-to-market loss of HK$4.159 billion with AUD$6.561 billion to be delivered under the contracts while, under the outstanding Euro denominated contracts CITIC was looking at a mark-to-market loss of HK$439.96 million.

(ii) At a spot rate of 0.8200 (Australian dollar/US dollar) and 1.43 (Euro/US dollar), under the outstanding Australian dollar denominated TRF contracts CITIC was looking at a mark-to-market loss of HK$6.002 billion with AUD$7.173 billion to be delivered under the contracts while, under the outstanding Euro denominated contracts CITIC was looking at a mark-to-market loss of HK$631.09 million.

[12] For ease of reference, the figures have been rounded off.

(iii) At a spot rate of 0.8000 (Australian dollar/US dollar) and 1.40 (Euro/US dollar), under the outstanding Australian dollar denominated TRF contracts CITIC was looking at a mark-to-market loss of HK$7.777 billion with AUD$7.735 billion to be delivered under the contracts while, under the outstanding Euro denominated contracts CITIC was looking at a mark-to-market loss of HK$816.33 million.

61. Appreciating the seriousness of the position, Mr Henry Fan had asked a number of other senior executives to attend the meeting. They included Mr Larry Yung, the Chairman, Mr Lee Chung Hing, Peter (‘Mr Peter Lee’), the Deputy Managing Director with special responsibility for business development and Mr Chau Chi Yin (‘Mr C.Y. Chau’), an Executive Director and Group Financial Controller.

62. Those who came to the Sunday meeting commented that Mr Leslie Chang appeared to be under very great emotional stress and, while they understood in broad terms what was being told to them, they had difficulty understanding more detailed aspects and in addition, found a number of inconsistencies in the figures that were laid before them.

63. In the result, a task force was set up that same day – the Sunday – to seek to discover the true nature and extent of the problem and to identify ways of dealing with it. Mr Leslie Chang, the victim of a major depressive disorder, could be of no assistance. The TRF contracts that had been entered into by CITIC were each bespoke instruments and were complex products. Understandably, it took time to come to grips with their complexity.

64. Because of the sensitivity of the matters confronting the task force, it was agreed that it would conduct its work on a confidential basis and because of that confidentiality it appears that nobody in the Company Secretarial Office which was responsible for making any amendments to the Dah Chong Hong circular and for putting it on the Stock Exchange website came to know what was happening. In the result, on 12 September 2008 the circular was published without change.

The Nature of the SFC Mandate

65. Consequent upon its investigations - particularly in light of the losses that the senior executives of CITIC had learnt the Company was facing at the Sunday meeting held on 7 September 2008 - the SFC (in its Notice of 11 September 2014) mandated the Tribunal to conduct an enquiry to determine two primary matters: First, whether, in the publication of the Dah Chong Hong circular containing the 'no material adverse change' statement, market misconduct within the meaning of section 277(1) of the Ordinance had taken place. Second, if so, the identity of any person who had engaged in that market misconduct.

66. Section 13 of schedule 9 to the Ordinance requires the SFC to specify the identity of those persons who, it is asserted, may have been culpable of market misconduct. Pursuant to this section, the following were specified in the notice:

(i) the company itself, that is, CITIC.

(ii) Mr Leslie Chang who at all material times held the position of Deputy Managing Director of CITIC and who, as part of his duties, discharged the responsibilities of Chief Finance Officer.

(iii) Mr Larry Yung who at all material times was the Chairman of CITIC, having been at the helm of the company since its establishment in 1987.

(iv) Mr Henry Fan who at all material times was the Managing Director of CITIC, having held that position since 1992.

(v) Mr Peter Lee who at all material times was the Deputy Managing Director of CITIC with special responsibility for business development.

(vi) Mr C.Y. Chau who at all material times was an Executive Director of CITIC and who, as part of his duties, discharged the responsibilities of Group Financial Controller.

67. The five directors who were identified as specified persons had each been at the Sunday meeting. Other directors who had authorised the publication of the Dah Chong Hong circular but had not been at the Sunday meeting were not identified.

68. As to the nature of the market misconduct asserted by the SFC, it was limited to misconduct within the meaning of section 277(1) of the Ordinance. That section states:

> "Disclosure of false or misleading information inducing transactions takes place when, in Hong Kong or elsewhere, a person discloses,

circulates or disseminates, or authorizes or is concerned in the disclosure, circulation or dissemination of, information that is likely –

(a) to induce another person to subscribe for securities, or deal in future contracts, in Hong Kong;

(b) to induce the sale or purchase in Hong Kong of securities by another person; or

(c) to maintain, increase, reduce or stabilize the price of securities, or the price for dealings in futures contracts, in Hong Kong,

if –

(i) the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact; and

(ii) the person knows that, or is reckless or negligent as to whether, the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact."

69. Section 277(1) of the Ordinance contains four essential elements. These four elements may be described by stating that market misconduct is committed if:

(i) a person, whether in Hong Kong or elsewhere, disseminates, or is concerned in the dissemination of information ('the publication element'), in the present case this being the publication of the Dah Chong Hong circular containing the assertion that the directors of CITIC were not aware of any material adverse change in the financial position of the Company;

(ii) the information is likely to induce dealing in securities in Hong Kong or is likely to "maintain, increase, reduce or stabilise the price of securities in Hong Kong" in Hong Kong ('the market effect element'); in the present case it being said that, against the background of turbulent markets globally, the assertion was likely to reassure the market and 'maintain' the price of CITIC shares;

(iii) the information is false or misleading as to a material fact or is false or misleading through the omission of a material fact ('the false or misleading element'), in the present case it being said that CITIC's derivatives exposure was of such a magnitude that, although there were not as yet any actual losses, that exposure itself (measured by way of mark-to-market losses and the cash flow stress of having to purchase highly leveraged amounts of currency) constituted an actual material adverse change in the Group's financial position, and

(iv) the person in question knows that, or is reckless or negligent as to whether, the information is false or misleading ('the fault element), in the present case the assertion being that each of the specified persons *knew* that the assertion of no material adverse change in the financial position of the

Company was false or misleading or was *reckless* or *negligent* as to that fact.

Matters Not Falling within the SFC Mandate

70. As just indicated, in his opening submissions, Mr Bell, on behalf of the SFC, said that, on a consideration of all the evidence, by the evening of 7 September 2008, after the Sunday meeting, all of the specified persons must have been aware that the exposure arising from the TRF contracts – encompassing both the contemporary mark-to-market losses and the potentially hugely increased amount of foreign currency deliverable under the contracts - amounted to a material adverse change to the 'financial' position of CITIC. That being the case, the 'no material adverse change' statement that was published five days later on the Stock Exchange website was false or misleading as to a material fact or was false or misleading through the omission of a material fact. Mr Bell said that one of the specified persons, Mr Leslie Chang, must have known of that fact, while the others must have been reckless or negligent as to it.

71. In his closing submissions, Mr Bell said that the 'no material adverse change' statement published on 12 September 2008 purported to give a 'clean bill of health' – a reassurance to CITIC shareholders and the market - in relation to the financial position of CITIC which was later contradicted by the profit warning issued by CITIC on 20 October 2008, that profit warning containing an acceptance that the Company had been aware of "its massive currency exposures"[13] since 7 September 2008.

[13] See the opening paragraph of his final written submissions.

72. In the result, said Mr Bell, between 12 September 2008, when the 'no material adverse change' statement was published, and 20 October 2008, when the profit warning was published, those in the market trading in CITIC securities did so under a false premise and suffered losses as a result.

73. On the basis of the case presented by the SFC, therefore, the basis of the market misconduct culpability alleged by it was essentially limited to a particular – and small – window of time, that is, from Sunday, 7 September 2008 when the Sunday meeting took place, through until the late afternoon of 12 September 2008, when the 'no material adverse change' statement, being part of the Dah Chong Hong circular, was uplifted to the Stock Exchange website.

74. Pausing for a moment, it should be said that during the course of the hearing, it appeared to be accepted that the window of time should be measured only up to and including 9 September 2008, that being the advertised latest practicable date and therefore the latest date up to which shareholders – they being the ones to whom the circular was addressed – would have understood the information as being applicable. The Tribunal was prepared to accept that measurement. It should be said, however, that, even if 12 September 2008 was chosen, there would have been no difference in the findings of the Tribunal

75. Of course, that is not to deny the relevance of events leading up to the Sunday meeting held on 7 September 2008. Nor is it to deny the relevance of subsequent events in so far as they may reflect back and thereby shed light on the issues to be determined pursuant to the SFC Notice.

76. On a reading of this report, it may be suggested that, in light of the continuing collapse of the Australian dollar (and other currencies) against the US dollar, it would have been prudent of CITIC to publish its profit warning well before 20 October 2008. It may even be suggested that, in terms of section 13.09 (1) of the Listing Rules[14], which imposes an obligation on listed companies to inform the Stock Exchange and its shareholders as soon as reasonably practicable of any major new developments that may be expected to materially affect the price of its securities, there was a regulatory obligation on CITIC to do so well before 20 October 2008. These matters, however, even accepting that the Tribunal's enquiry is essentially an inquisitorial one and reasonably broad, have *not* formed part of the mandate given to it.

77. To repeat, the Tribunal's mandate, while it has encompassed all relevant evidence whatever the timing and nature of its provenance, has essentially been focused on a compact period of time, indeed a period of some six days.

78. Nor has it been part of the Tribunal's mandate to apportion blame in respect of the wisdom or otherwise of commercial decisions made. As the Tribunal has noted in the opening paragraph of this report, during the course of the enquiry a great many issues were canvassed. By way of example, with the wisdom of hindsight it may perhaps be said that the use of TRF contracts as a hedging tool should never have been contemplated or, if

[14] The section reads as follows:

"Generally and apart from compliance with all the specific requirements in this Chapter, an issuer shall keep the Exchange, members of the issuer and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new development in the group's sphere of activity which is not public knowledge) which:

a) is necessary to enable them and the public to appraise the position of the group; or
b) is necessary to avoid the establishment of a false market in its securities; or
c) might be reasonably expected materially to affect market activity in and the price of its securities."

contemplated, that the global financial crisis that was emerging in the summer and autumn of 2008 should have dictated a far more cautious approach than the one adopted by those within CITIC who had management of the Sino Iron Project's hedging policies. It is to be emphasised, however, that it has never been the Tribunal's function to determine the wisdom of CITIC's hedging policies at the material times nor, if any blame be apparent, to apportion such blame between the specified persons.

79. The responsibility of the Tribunal in this enquiry has been limited to determining in respect of each of the specified persons - their cases being considered separately - whether each of the four elements of section 277(1) that are set out above have been demonstrated and, if so, in respect of the fault element, the degree of culpability – if any - of each of the specified persons.

CHAPTER TWO

LOOKING MORE CLOSELY TO EVENTS LEADING TO THE HEDGING CRISIS

Considering Matters within the Context of the 'No Material Adverse Change Statement'

80. Prior to its publication on the Stock Exchange website, the wording of the Dah Chong Hong circular had been approved by the Stock Exchange. Within that circular, the 'no material adverse change statement' began with the words:

> "Save as disclosed in this Circular, the directors are not aware of any material adverse change in the financial … position of the Group since 31December 2007…"

81. Accordingly, for that (duly approved) statement to be demonstrated to be false or misleading as to a material 'fact' it fell to the SFC to demonstrate, first, that by the latest practicable date, namely, 9 September 2008, there was in existence a material adverse change in the financial position of CITIC as opposed to a prospective or threatened material adverse change and, second, that the directors had knowledge of that 'fact'.

82. In the content of this enquiry, a 'fact' may be said to be an item of verified information, a thing that is known to be true. To be aware of a fact, therefore, is not simply to suspect that a matter may be true or to be

concerned that it may be true, it is to have knowledge of its independent reality.

83. In the judgment of the Tribunal, when looking more closely to the events that led to CITIC's hedging crisis, it is important to do so within the context that has just been set out and to recognise that not all of the specified persons who were Executive Directors were aware at all times of the intricacies of the hedging policy that had been adopted to manage the foreign currency risks of the Sino Iron Project. By way of illustration, the evidence presented to the Tribunal revealed that Mr Larry Yung, the Chairman, and Mr Henry Fan, the Managing Director, the two most senior decision-makers, only became aware of a mark-to-market hedging loss of any kind on 3 September 2008 and were only given detailed scenarios pointing to an exposure crisis at the Sunday meeting.

Early Recognition of Risks by Those Tasked to Manage the Hedging Policy

84. That said, it is apparent from the evidence that from the outset those in the senior management of the CITIC Group charged with the day-to-day task of hedging the Sino Iron Project understood that the employment of accumulators - TRF contracts - presented a very particular risk.

85. When the proposal to use TRF contracts was first put to him, Mr Leslie Chang, CITIC's Chief Finance Officer, was instinctively sceptical. Mr Simon Chui, who was then the Assistant Director of the Hong Kong Finance Department (and who had been approached by one of CITIC's bankers promoting the concept) accepted their inherent risks. In an email to Mr Leslie Chang, he said:

> "You are right, there is no free lunch. In this structure, CP's [CITIC's] upside is limited (up to US$2 million). Our downside (if AUD/USD drops below 0.78) can be very significant. Take an extreme example, if AUD/USD drops to 0.75 and maintains this level for 12 months, our loss would be US$6 million."

86. Mr Leslie Chang replied that they needed to be careful when considering complicated structures promoted by banks. He agreed that the prospect of the Australian dollar falling below 0.75 was not impossible. He ended by saying:

> "Let's go over the structure in more detail next week to see if we can mitigate the risks. *I am not too concerned about the accounting loss, effective cost or economic substance is more important.*" [emphasis added]

87. Despite Mr Leslie Chang's concerns, in the face of an increasing requirement for Australian dollars to finance the construction of the Sino Iron Project coupled with the continued strength of the Australian dollar as against the US dollar, it was determined that TRF contracts would have to be employed. The first Australian dollar/US dollar contract was entered into in the latter part of September 2007. Two more contracts were entered into in October and in November.

88. However, the concerns as to risk were always present. In an email dated 24 January 2008 sent by Mr Charles Yau, the Chief Financial Officer of CITIC Mining Management, to Mr Simon Chui, the following was said:

> "For your information and action, ExCo members decided no further target redemption forward contracts will be utilised for hedging

> purposes in our ExCo meeting yesterday. I would also be glad to have your advice for our hedging policy covering structural products."

89. Discussion followed. In an email dated 18 February 2008, Mr Simon Chui informed the ExCo of CITIC Mining Management that, in view of the gap between the current Australian dollar rate (0.91) and the budget rate (0.80), it was difficult to accumulate sufficient Australian dollars without using structured instruments. As to the use of these instruments to date, Mr Simon Chui said that they had been knocked out within one to three months.[15] As to alternatives, he said:

> "We can always wait for a big correction on the Australian dollar rate so that we can lock in the Australian dollar at our desirable rate. However, banks' economists do not expect a big correction on the Australian dollar rate …"

90. In a hedging update sent to CITIC Mining Management, the Hong Kong Finance Department reported that:

> "Up to 31 January 2008, these contracts have realised AUD 231 million at an average forward rate of 0.7913. The achieved forward rate is significantly favourable compared to the average market spot rate of 0.88 for the period from September 2007 to January 2008. At 31 January 2008, eight remaining target redemption forward contracts existed, with these contracts expected to realise AUD 158 million at an average rate of 0.7822. This compares very favourably with the current spot rates in the order of 0.90."

91. In the same background paper, concerning the continuing strength of the Australian dollar, and the need thereby to continue employing TRF

[15] A profit had therefore been made on each.

contracts as a hedge, it was noted that the Reserve Bank of Australia had lifted the official cash rate by 25 basis points to 7% and commented:

> "Though there are significant risks of a US recession and global slowdown, given wider interest rate spreads, firmer commodity prices and improved risk appetite, market cannot see a dramatic fall in AUD/USD until the Reserve Bank of Australia cuts rates."

92. In the result, it was agreed between the Hong Kong Finance Department and the ExCo of CITIC Mining Management that TRF contracts would continue to be employed but only within the constraints of a three-stage policy. That policy was defined as follows:

> "1. <u>Determine the AUD requirement</u>
> The AUD [Australian dollar] requirement of the project should be determined and updated every month.
>
> 2. <u>Monitor the expected hedged amount</u>
> Expected hedged amount means the aggregate AUD amount to be delivered from all the outstanding target redemption forwards, as calculated by the current spot AUD/USD rate. The expected hedged amount should be monitored on daily basis and should be lower than the AUD requirement at all times. No further hedging contracts can be entered into if this condition is not fulfilled.
>
> 3. <u>Statistic analysis before entering into new contracts</u>
> Before entering into new transactions, statistic analysis (using five-year historical figures and 5% confidence interval) should be conducted. The new transactions can be entered into if there is more than 95% possibility that the transaction can be early terminated within six months' time (i.e. for an AUD 10M

> transaction, the AUD amount to be delivered is expected to be less than AUD 60M)."

93. During the course of submissions, a number of criticisms were levelled at the structural integrity of this policy. In the view of the Tribunal, however, for the purposes of this report, it has not been necessary to consider its relative strengths and weaknesses.

94. Following the implementation of the new policy, relatively fewer Australian dollar/US dollar TRF contracts were concluded. From March 2008 through until the end of June 2008 CITIC only entered into six new contracts.

95. As at 30 June 2008, it appears that CITIC held three outstanding Australian dollar/US dollar TRF contracts, eight outstanding Euro/US dollar TRF contracts and three outstanding renminbi/US dollar contracts.

96. In July 2008, however, CITIC entered into 11 new Australian dollar/US dollar TRF contracts. These new contracts were more aggressive in that they carried a potential for greater profit but also carried greater risk. As to risk, by way of example, although the leverage ratio in previous contracts had been 2, the leverage ratio for nine of the new contracts was 2.5 while one contract was set at 3. Put simply, in respect of the contract with a leverage ratio of 3, it meant that, if the Australian dollar/US dollar spot rate fell below the contracted strike rate, then CITIC would not only have to receive Australian dollars at a rate higher than the market rate, it would be contractually obliged to receive three times the amount.

97. Mr Leslie Chang was concerned at this increased level of risk but nevertheless agreed to continue purchasing more TRF contracts. On 17 July 2008, in an email to Mr Simon Chui, he said:

> "Yes, please go ahead. My personal view is that it is likely that more bad news will come out of the US, plus the uncertainties of the financial market, the US dollar may be weak for a while. Although I believe next year the US dollar will rebound, but we need more Australian dollars in the near term. As such, we should be a bit more aggressive."

98. In so far as it is relevant to the issues that fall for determination by the Tribunal, it was emphasised by Mr Bell, the Presenting Officer, that, although Mr Leslie Chang may have believed that he was using the TRF contracts for legitimate hedging purposes, viewed objectively, he was speculating. This was because his rationale for entering into the TRF contracts - more particularly in July and August 2008 when he agreed to more aggressive and riskier contracts - was based on predictions as to the movement of the Australian dollar spot rate.

99. As to that movement, on 15 July 2008, the Australian dollar reached an all-time high of 0.9827, there being concerns that it would shortly exceed the value of the US dollar. However, it then started to decline, decreasing to 0.9439 by 31 July 2008. As indicated earlier in this report, this was seen by Mr Leslie Chang as a good opportunity to enter into new TRF contracts. On 25 July 2008 he sent an email to his staff in the Finance Department saying:

> "Please note that the US dollar continued to strengthen tonight. As discussed with Winnie today, let's take advantage of the current

> recovery (expect the foreign exchange market will remain volatile for this year) to increase our Australian dollar hedging ratio. My initial target is to increase our outstanding contract amount (including the expected deliveries) to about 500 million by the end of July."

100. In CITIC Mining Management's ExCo report for July 2008, the following was said in respect of foreign exchange exposure to the Australian dollar:

> "Foreign exchange forward contracts and structured forward instruments have been employed to hedge the Australian dollar exposure. Considering that the current rate (0.9423 as at 31 July 2008) is higher than the budget rate of 0.79, target redemption forwards [TRF contracts] are utilised for hedging at more favourable rates. During July 2008, we have entered into 11 new target redemption forward contracts with a projected deliverable amount of AUD$257 million.
>
> Up to 31 July 2008, totalling AUD$1,046 million was hedged against the US dollar (weighted average rate of the Australian dollar/US dollar at 0.79). Of this amount, AUD$529 million has already been spent and the remaining forward contracts outstanding of around AUD$517 million can be utilised for future Australian dollar payment requirements.
>
> In view of the large Australian dollar requirement for the project, we would like to keep outstanding hedging amount above AUD$500 million. Structured derivative products will be carefully implemented to lower our hedging costs while keeping the hedging risk under control."

101. In the first week of August 2008, the Australian dollar continued its fall against the US dollar, the rate on 11 August 2008 being 0.8902. Mr Leslie Chang, however, was of the view that the fall was only temporary. In an email to Mr Simon Chui, he said that he did not believe the recent fall in the value of the Australian dollar was due to the economic fundamentals.

102. In the result, as Mr Bell put it in his final submissions, as at 11 August 2008 CITIC held a total of 16 Australian dollar/US dollar TRF contracts with a total maximum exposure of almost AUD$9.4 billion.

The Collapse of the Australian Dollar

103. As the graph – Annexure C to this report - illustrates, from the last few days of July 2008 to the latter part of October 2008, with the exception of a limited rebound in September 2008, the Australian dollar collapsed in value. That collapse was, as commentators now appreciate, bound up within the maelstrom of the global financial crisis. At the time, however, as the Tribunal has observed earlier in this report, a collapse of that magnitude could not have been anticipated. As earlier observed, a number of counsel referred to it as a 'black swan' event.

104. That collapse of the Australian dollar (together with the euro and the renminbi) occurred within the context of the purchase by CITIC in June, July and August 2008 of 16 TRF contracts, most containing far riskier features than the earlier contracts. It was the obligations contained in *these* complex derivatives that precipitated the very grave losses sustained by the Company and were the cause of the profit warning published on 20 October 2008 (when the Australian dollar: US dollar rate was at its nadir).

105. By the 12 August 2008, increasing caution was apparent in the workings of the Hong Kong Finance Department. On that day, Mr Leslie Chang sent an email to Mr Simon Chui:

> "Noted that the US dollar continues to advance against all currencies and notably Euro and Australian. Please take a look at our OS [TRF] contracts and do some sensitivity analysis on the exposure. What will be our position, say, Australian moves to 0.85 and Euro to 1.45?"

106. On 13 August 2008, Ms Winnie Tse Wai Ping ('Ms Winnie Tse'), an assistant manager in CITIC's Finance Department, made the relevant calculations, informing Mr Simon Chui by email that, at the Australian dollar: US dollar rate of 0.85, the projected hedged amount would be AU$6.795 billion. This email was not sent to Mr Leslie Chang.

107. On 19 August 2008, Mr Charles Yau (of CITIC Mining Management) sent an email to Mr Simon Chui in which he said that, while he fully understood that the drastic change in the increase in the value of the US dollar as against other currencies had not been expected, and while it was too early to form the view that the US dollar had reversed its weakening trend, nevertheless close attention had to be paid to CITIC's exposure both in terms of cash flow and the impact on the accounts. In this latter regard, he recommended that there should be close monitoring of the impact of mark-to-market valuations.

108. Certainly, Mr Vernon Moore, a past Chief Financial Officer of CITIC and still an Executive Director sitting on the ExCo of CITIC Mining Management, was well aware that the TRF contracts, by their asymmetrical nature, would not qualify as hedging instruments under the relevant

accountancy standards and as a result would have to be reflected on a mark-to-market basis in the profit and loss account. He attended the ExCo meeting on 20 August 2008 and recorded his evidence that:

> "I said to this meeting, that's not the right pattern for a hedging transaction. Hedging is supposed to be symmetrical. There shouldn't be a situation where if you get to a point, one of the variables, you get a loss. So the graph displayed a character which you wouldn't expect for the transactions that we were supposed to be doing."

109. By 30 August 2008, Mr Leslie Chang was clearly deeply concerned. In an email of that date addressed to Mr Simon Chui he said the following in respect of the Australian dollar/US dollar TRF contracts:

> "Have you completed the sensitivity analysis on the swap position we discussed yesterday? I am really concerned about the position we are in. I looked at the list you gave me yesterday again. If I am correct, we started the position as at 30 June with available and expected balance of about 380 million. Right now, we have only one outstanding contract of 8 million that was traded before the end of June. On the other hand, altogether 11 contracts were traded in July with a notional amount totalling 125 million, and all of these contracts were with 'step-up' structure! (I sent out an email on 6 July stating that I am not in favour of this type of structure but noted that the first trade with the feature was entered into on 8 July with Citibank). This was followed by another four contracts traded in August totalling 35 million. No matter how I look at these trading positions (actual or expected) clearly the total balance was far exceeded 500 million target long ago. Obviously, this was out of control."

110. In the same email, he made the following comments in respect of the Euro/US dollar TRF contracts:

> "During the same period, several Euro target redemption trades were also entered. I have stated on several occasions that we should only maintain a low hedging position of about 20 to 30% for the Euro exposure. In the light of Larry's [Mr Larry Yung's] personal outlook on the Euro, I have also said around 1.40 is the level I would feel more comfortable. But it seems that we continue to trade with increasing aggressive structure. I noted that there are three contracts entered in July which all require the spot level to go above 1.61 (as high as 1.6564) to knock out these contracts in three months! I am surprised that we would take such an aggressive approach."

111. Mr Leslie Chang concluded by saying:

> "Needless to say, I shall take the ultimate responsibility for the results. But we must learn the lessons and need to improve our internal control system (clearly lacking proper analysis before and after such trading). Right now, the most important thing is to take appropriate measures to control the damage. Please make this a priority to find the best way to minimise the exposures."

Interim Results

112. On 28 August 2008, a CITIC board meeting took place. The principal purpose appears to have been to approve the announcement of the Company's interim results which were in fact published that same day.

113. It appears from the minutes and the accompanying board papers that, in respect of CITIC's hedging difficulties, Mr Leslie Chang only

reported the position as at 30 June 2008, that being the position appearing in the interim results. At that date, the Australian dollar rate to the US dollar had stood at 0.9637 in contrast to the rate on the day before the board meeting: 0.8618.

114. When Mr Leslie Chang was asked in cross-examination why he had not provided the board with fully up-to-date hedging information, he replied that, with the benefit of hindsight, he should have done so but that the principal purpose of the meeting, as he understood it, had been to approve the interim results and it was possible that at the time he had still not fully appreciated the significance of the strengthening of the US dollar.

115. In the interim results, that is, for the six months ended 30 June 2008, under the heading of 'Foreign Currency Exposure' the following was said:

> "A portion of the Iron Ore Mining project development costs, as well as certain pre-completion expenditures, required paying in non-USD currencies. Foreign exchange forward contracts and structured forward instruments are employed to hedge or minimise these currency exposures. As at 30 June 2008, outstanding foreign exchange forward contracts and structured forward instruments amounted to HK$3.9 billion (31 December 2007: HK$3.5 billion)."

Events in Early September 2008

116. On 1 September 2008, with CITIC Mining Management's July accounts for the Sino Iron Project showing a total mark-to-market loss occasioned by foreign currency exposure under the TRF contracts in the region of HK$500 million, Mr Alan Lee, the Assistant Director of CITIC's

Accounts Division, sent an email to Mr Charles Yau, copied to Mr Leslie Chang and Mr Simon Chui, which (in part) said:

> "The amount involved is very significant, talking about a loss of HK$520 million and HK$350 million for pre-tax and after-tax, respectively. The issue should be addressed as soon as possible and seriously. I would suggest to have a telephone conference early tomorrow morning, say, 9:30 AM so that you can talk to Simon [Chui] directly to get what you need for the projection. Some of the major questions that come out of my mind are:
>
> How much of the loss recorded in July will be reversed before the end of 2008?
>
> Is it confirmed that the loss that will be realised in the remaining period of 2008 can be debited to the reserve, instead of profit and loss account? Has this been confirmed by the auditors?"

117. A telephone conference took place on the morning of 2 September 2008, the participants (so it appears) being Mr Simon Chui, Mr Charles Yau, Mr Alan Lee and Ms Jenny Cheung, the General Manager of CITIC's Accounts Division. At the end of that conference, Ms Jenny Cheung sent out an email summarising what had been discussed during the meeting and ending with the following remark:

> "The full year projection of the MTM value is assumed to be break-even ."

118. Exactly who had made that projection was never identified with certainty during the course of the enquiry nor was the basis for making it. But it appears to have had some influence on subsequent actions.

119. Mr Charles Yau, however, was not convinced as to the accuracy of this prediction. In an email of the same date, he commented:

> "As discussed before, outstanding financial instruments will have huge impact on our financial accounts. With the recent appreciation of USD, the mark-to-market losses will get bigger. I don't have the exact figures as these must be calculated by banks with highly sophisticated programmes."

120. On 3 September 2008, Mr C.Y. Chau, one of the specified persons, an Executive Director and Group Financial Controller, made a report to Mr Henry Fan, CITIC's Managing Director, informing him of an estimated foreign currency loss of HK$374 million for the month of July 2008. Mr C.Y. Chau gave evidence that he was not overly concerned as 'one of the colleagues' had estimated that the foreign currency losses would result in a break-even situation by the end of the year. Mr Henry Fan, however, said that he was surprised as he had not expected a hedging loss of that magnitude.

121. Mr Henry Fan reported to Mr Larry Yung, the Chairman. Mr Larry Yung, in his evidence, recalled being informed of the loss arising out of hedging the Australian dollar. He said that he was surprised as no such loss could arise by way of "direct hedging": the plain vanilla hedging that he had anticipated would only be used. He said that he attempted to contact Mr Leslie Chang in order to obtain an explanation from him but was told that Mr Leslie Chang was on a business trip and would only return on 5 September 2008. He therefore asked Mr Henry Fan to look into the matter.

The CITIC ExCo Meeting of 4 September 2008

122. On the following day, 4 September 2008, there was an Executive Committee Meeting of CITIC held in the offices of the Hong Kong headquarters.[16] In the report prepared for the meeting, among the many other matters that fell for consideration, the hedging troubles were explained in some detail.[17]

123. In the report, the nature of TRF contracts was set out for the benefit of those at the meeting, especially their leveraged nature. The report went on to say:

> "Recently, however, the AUD/USD spot rate dropped unexpectedly from the peak of 0.98 to 0.88 within two weeks, and this sharp fall has been over 13% by the end of August. The movement has lengthened the expected life of our hedging contracts and caused drastic change in our hedging position for the AUD. As at 22 August 2008, the expected deliverable amount based on the spot rate on that date was AUD 3,510 million. As described above, the expected deliverable amount will be varied based on different spot rate assumptions. For example, the spot rate of 0.93, 0.88 and 0.86 (the market believed that these rates were important supporting levels for the AUD), the accumulated deliverable amount would be AUD 610 million, AUD 890 million and AUD 6,120 million respectively for the entire life of the contracts.

[16] Those who attended the Executive Committee Meeting included Mr Henry Fan, the Managing Director of CITIC; Mr Carl Yung, Deputy Managing Director of CITIC; Mr C.Y. Chau, an Executive Director of CITIC and the Group Financial Controller; Mr Steve Kwok, an Executive Director of CITIC and the man in charge of the Business Development Department and Ms Frances Yung, the daughter of the Chairman, Mr Larry Yung, and the Director of the CITIC Finance Department.

[17] On 3 September 2008, the day before the meeting, that being the day when the report was circulated, the AUD:USD spot rate had fallen to 0.8296.

> Comparing with our AUD capex [estimated capital expenditure] and pre-completion expenditure of AUD 1.6 billion, we are at risk that the expected deliverable amount may be significantly higher than the required AUD amount based on the current level of exchange rate."

124. The report went on to outline what was being done:

> "We are exploring different alternatives to restore a proper hedging ratio. On the other hand, as all the outstanding hedging contracts have 24 monthly fixing, if the exchange rates continue to stay low, there will be no early termination and the contracts will run well into the operational period of the mine. We are also evaluating whether we can allocate part of the future deliverable amount to cover the operating costs which are estimated to be over AUD 1 billion annually …"

125. The report also spoke of the potential exposures under other foreign currencies, namely, the euro, the renminbi, the krona and the yen.

126. The minutes of the meeting revealed that the hedging troubles had been discussed. In this regard, the minutes said:

> "In response to the question raised by Mr Henry Fan [Managing Director of CITIC] about the situation of the Australian dollar hedging, Ms Frances Yung [the Director of the Finance Department][18] responded that measures were under study trying to mitigate the hedging loss. Mr C.Y. Chau [the Group Financial Controller] supplemented [by saying that] the hedging loss was about HK$390 million and only 20% to 30% of the Australian dollar was hedged *and so the drop in Australian dollar should be beneficial to*

[18] Mr Leslie Chang, CITIC's Chief Finance Officer, was not present at this meeting. He was travelling on business. Ms Frances Yung, therefore, spoke on his behalf.

> *the overall Iron Ore project.* Mr Henry Fan instructed Mr C.Y. Chau to look into the details with the Finance Department." [emphasis added]

127. Clearly, on the face of the minutes, no great concern appears to have been shown by those at the Executive Committee Meeting as to the over hedging position. To the contrary, Mr C.Y. Chau appears to have been of the view that the fall in the strength of the Australian dollar as against the US dollar would be beneficial.

128. In his witness statement prepared for the enquiry before the Tribunal[19], Mr Henry Fan said that, given what Ms Frances Yung and Mr C.Y. Chau had told him during the meeting, he believed that the situation was under control. He gave a number of reasons for this. First, active measures to counter-hedge and to mitigate were being taken; second, he believed that the investigations to be conducted by Mr C.Y. Chau would help to identify and manage further potential exposure and, third, the estimated foreign currency loss of HK$374 million for the month of July, was not a substantial amount when compared with CITIC's "profit of over HK$10.8 billion and net assets of over HK$64.6 billion for 2007".

The Alarm Raised

129. While CITIC's Executive Committee was meeting on 4 September 2008, Ms Winnie Tse of CITIC's Finance Department was in the process of compiling an up-to-date risk exposure analysis in respect of all outstanding TRF contracts, principally those denominated in Australian dollars, but also those denominated in euros and a number of contracts that were dual

[19] Dated 7 August 2015.

currency: denominated in both euros and Australian dollars. In order to ensure both the accuracy and the breadth of the analysis, she sought from the counterparty banks the mark-to-market values at different spot rates. In respect of the Australian dollar denominated contracts, there were three spot rates, namely: 0.8000; 0.8200 and 0.8500. In respect of the euro denominated contracts, the spot rates were set at 1.40; 1.43 and 1.45.

130. At about 10:30pm that night, with the analysis substantially completed, she sent the analysis under cover of an email to Mr Simon Chui, her superior in the Finance Department, who had instructed her to undertake the work. In her covering note, she confirmed that the figures had been checked by another senior officer in the Finance Department.

131. The analysis revealed that as at 29 August 2008, the mark-to-market loss of all outstanding TRF contracts had amounted to HK$3.17 billion (HK$332 million from TRF contracts denominated in euros and HK$2.838 billion from TRF contracts denominated in Australian dollars).

132. The scenarios that had been prepared also contained summaries of outstanding TRF contracts at different spot rates. Those summaries were put into a table by Ms Stella Fung Sau Hong (‘Ms Stella Fung’) in her expert report dated 7 November 2014 -

AUD/USD EUR/USD Spot rates	Contract	MTM profit/(loss)	Expected amount of AUD and EUR to be delivered under the contracts
0.8000 / 1.40	AUD TRF	(HK$7,777.94 million)	AUD 7,735,571,429
	EUR TRF (incl. DCTRF)	(HK$816.33 million)	AUD 846,897,590 + EUR 218,305,606
	Total	**(HK$8,594.27 million)**	**AUD 8,582,469,019 + EUR 218,305,606**
	AUD TRF	(HK$6,002.99 million)	AUD 7,173,529,412

AUD/USD EUR/USD Spot rates	Contract	MTM profit/(loss)	Expected amount of AUD and EUR to be delivered under the contracts
0.8200 / 1.43	EUR TRF (incl. DCTRF)	(HK$631.09 million)	AUD 539,676,739 + EUR 154,235,351
	Total	**(HK$6,634.08 million)**	**AUD 7,713,206,151 + EUR 154,235,351**
0.8500 / 1.45	AUD TRF	(HK$ 4,159.66 million)	AUD 6,561,443,452
	EUR TRF (incl. DCTRF)	(HK$439.96 million)	AUD 144,041,616 + EUR 173,059,088
	Total	**(HK$4,599.62 million)**	**AUD 6,705,485,068 + EUR 173,059,088**

133. It was on the afternoon of 5 September, having returned from his business trip, that Mr Leslie Chang sat with Mr Simon Chui and Ms Winnie Tse to consider the sensitivity scenarios that Ms Winnie Tse had been working on over the past two days. He was shocked by what he read. In respect of the Australian dollar-denominated TRF contracts, in his witness statement[20], he said that, on the basis of Ms Winnie Tse's sensitivity analysis, the mark-to-market loss as at 29 August 2008 had been HK$2.838 billion. The projected losses at 0.85 were HK$4.159 billion, at 0.82 they were HK$6 billion and at 0.80 they were HK$7.777 billion.[21]

[20] Dated 7 August 2015

[21] Evidence was placed before the Tribunal that Mr Leslie Chang was at the time under considerable stress and suffering from depression. His witness statement was worded, therefore in the context of his depressive condition. As to his reaction when he first considered Ms Winnie Tse's sensitivity analysis, he wrote the following in his statement:

"I remember listening to Simon [Chui] and Winnie [Tse] but I could not help focusing on the MTM losses. On the dual currency summary sheet, there was an MTM loss as at 29 August 2008 of HK$332 million, and on the projected rates of US$0.85, US$0.82 and US$0.8, there would be losses of between HK$440 million and HK$816 million. I quickly looked through the supporting calculations at the back of the summary to check the losses and also leafed through the projected delivery of Australian dollars at various Australian dollar support levels. I do not recall focusing on the total figures at the end of the projections, but when I came to the summary page for Australian dollars. I recall my mind going blank for a brief while, and when I looked at the MTM loss of HK$2.838 billion as at 29 August 2008 I could feel my heart sink. I looked at the projected losses on the same Australian dollar support levels which were HK$4.159 billion, HK$6 billion and HK$7.777 billion and I could not believe what I was seeing. The numbers did not register in my mind and I looked at them for a long time without saying anything. I was very confused, disappointed and angry, but mainly felt disbelief."

The 'Sunday Meeting'

134. Having worked with Mr Simon Chui through Saturday and into the evening, a little after midnight – in the early hours of Sunday, 7 September – Mr Leslie Chang sent the following email to Mr Henry Fan:

> "I am sorry to bother you on the weekend. I would like to request a meeting with you if possible to report our hedging trading position.
>
> Due to the unexpected drastic changes in the FX market recently, and in particular the continued free fall in Australian and Euro against the US dollar in the last few days, *we are facing huge losses on our outstanding hedging contracts on a mark-to-market basis*. We have been working on the market scenario analysis for all of our outstanding hedging contracts yesterday and again today. We also worked with our counterparties for their input on mark-to-market as well as potential ways to mitigate the impact. Originally, we planned to report the matter to you first thing on Monday but, as the matter is so important and has been bothering me deeply, I would really like to have an opportunity to give you a briefing in person as soon as possible." [emphasis added]

135. The meeting took place that Sunday at around mid-morning in the CITIC offices. Initially, Mr Leslie Chang met with Mr Henry Fan. However, when Mr Henry Fan appreciated the seriousness of the problem, he invited Mr Larry Yung and others to join the meeting, specifically, Mr Peter Lee, Mr C.Y. Chau and Mr Albert Tam, Head of Treasury Department of CITIC HK (Holdings) Limited.

136. On all the evidence, it was apparent that Mr Leslie Chang was under very considerable stress at the meeting. In the circumstances, and having regard to the seriousness of the potential problems facing CITIC, it is understandable that each of those attending would have slightly different recollections as to exactly what was said.

137. Initially, when Mr Leslie Chang met with Mr Henry Fan, he explained that the foreign currency exposure brought about by the use of TRF contracts was more severe than the HK$374 million mark-to-market loss that had been reported for the end of July. He gave Mr Henry Fan various sheets of paper setting out various scenarios. When he gave evidence, Mr Leslie Chang recalled that, although he and his team had worked on the position as at 4 September, he had used 29 August as the base in order to explain the situation to Mr Henry Fan because the mark-to-market information was more accurate for that date. He said that he also attempted to explain the leverage and step-up features of the TRF contracts and why it had been necessary, in his opinion, to enter into risky contracts of this kind in order to achieve the budget rate for the Sino Iron Project.

138. Mr Henry Fan recalled that Mr Leslie Chang was in an emotional somewhat confused state but that he was able to obtain a broad understanding of the serious situation confronting them. He then called Mr Larry Yung, gave him a brief report and it was agreed that Mr Larry Yung would come to the office. They were joined, as said earlier, by Mr Peter Lee, Mr C.Y. Chau and Mr Albert Tam.

139. Mr Leslie Chang addressed the meeting in order to explain the fundamental features of the TRF contracts and how, with the unprecedented rise in the value of the US dollar against the Australian dollar and other

currencies, the over-hedging had occurred. As to the estimated losses, Mr Leslie Chang said that he explained that the losses appearing in the further scenario analyses were no more than 'projected' losses – they were not actual losses – and that any final loss would be dependent upon spot rate changes in the future, that is, on the movement of the relevant currencies.

140. All those who had been brought to the meeting commented upon the fact that Mr Leslie Chang was clearly under great stress, there being different opinions as to the effectiveness of his explanations. Indeed, it is apparent that everybody at the meeting was under a degree of stress. At one stage, Mr Larry Yung lost his temper, banging his fist on the table and shouting at Mr Leslie Chang.

141. Those at the meeting, however, appear to have understood that CITIC was facing a potential loss of HK$4 billion to HK$6 billion with the deliverables in the region of AUD$6 billion to AUD$7 billion but that, if the Australian dollar rebounded, the potential losses would disappear or be greatly diminished.

142. In his witness statement of 4 August 2015, Mr Larry Yung said that, while he understood the broad outlines of what was being explained by Mr Leslie Chang –

> " … he was very nervous and also very confused at that time, and was not able to explain clearly or state how much the potential losses would be."

143. Mr Peter Lee, in the course of his evidence, also accepted that he understood the broad position but he qualified this by saying that at that

point of time nobody could be certain as to the exact position in respect of a number of very material matters. By way of example, he said that he remembered that –

> " … at the same exchange rate of 0.8, one of these so-called sheets thrown on the table showed HK$4 billion potential loss, but with the same exchange rate another sheet showed, so-called with the wording of MTM, HK$6 billion. Of course, some people asked him: "why, at the same exchange rate, have we got this 4 billion and 6 billion; which one is correct?" He could not give a good answer."

144. It also appeared that Mr Leslie Chang proposed the use of derivatives described as 'decumulators' in order to attempt to mitigate the situation. Mr Peter Lee's reaction was to the following effect:

> "But obviously that one is totally illogical. We don't want to be in a frying pan and then jumped into another one."

145. In the result, Mr Larry Yung made the decision to set up a task force. With potential losses so high it was determined that the relevant facts must first be ascertained and solutions found as quickly as possible to tackle the problems that presented themselves. Mr Larry Yung explained the essential objects of the task force as being –

(i) to promptly ascertain and clarify the potential losses and further risks;

(ii) to consider and ascertain whether the TRF contracts could be transferred to and borne by the project company;

(iii) to discuss with the accountants, the most appropriate way of treating the potential losses; and

(iv) to explore the possibility of novating the TRF contracts to third parties in order to reduce the risks of CITIC incurring further losses.

146. Mr Larry Yung said that he and Mr Henry Fan –

> " … reached a consensus after discussions that the TRFs involved should be unwound as soon as possible so that we could crystallise and confirm the losses actually suffered. As I saw it, until the losses were crystallised and confirmed, this uncontrollable and potentially bottomless exposure would hang over the head of CITIC Pacific like Damocles' sword, and CITIC Pacific would not have been able to continue to operate and carry on its business normally; this situation would not be acceptable."

147. Mr Leslie Chang was not included in the task force, being told not to have any further involvement with the hedging issue. Instead he was asked to prepare a report on the history of the hedging.

148. As to the work allocated to those who were included in the task force, the following is a summary:

(i) Mr Larry Yung himself would look to unwinding the TRF contracts in order to reduce on-going losses;

(ii) Mr Henry Fan would look to legal issues;

(iii) Mr Peter Lee would assess whether the TRF contracts could be transferred to Sino Iron/CITIC Pacific Mining, absorbed into the Sino Iron Project over the term of its existence; and

(iv) Mr C.Y. Chau would discuss with CITIC's accountants the most appropriate accounting treatment, particularly whether it would be possible to avoid booking any eventually realised mark-to-market losses into the profit and loss account and instead treat such losses as qualifying for hedge accounting.

149. As a result of a discussion between Mr Larry Yung and Mr Henry Fan, it was further agreed at the meeting that, because of the highly sensitive nature of the issues that were being faced, strict confidentiality would have to be maintained. Only those people drafted in to assist in the investigations would be made privy to the problems facing the Company: in short, knowledge would be on a 'need to know' basis.

The Relevance to the Enquiry of Mr Leslie Chang's Medical Condition

150. That night, Mr Leslie Chang informed his wife that he wished to resign and confided in her that he was again feeling unwell as a result of depression. He drafted a resignation letter and sent it by email to Mr Henry Fan. Early the following morning – the Monday – Mr Henry Fan replied, refusing his resignation and saying that, while he would not be responsible for hedging activities, he would continue to discharge all his other functions.

151. Mr Leslie Chang was called to Mr Larry Yung's office at about mid-morning on the Monday and again his attempt to resign was refused.

He broke down. On his return to his office, his wife spoke to him to say that Mr Larry Yung was deeply concerned as to his state of health.

152. It was the opinion of Dr Barry Connell, a psychiatrist whose opinion was not challenged, that from about 5 September onwards Mr Leslie Chang had been–

> "… in a highly distressed, stressed and depressed state which rendered his ability to pay attention and concentrate on his normal everyday tasks and functions, including at work, severely limited. Such a mental state would have likely additionally affected his ability to think clearly or exercise his normal level of judgement."

153. The weight of the evidence, therefore, points to the fact that, from about the time of his return from his business trip when he was first confronted with the analyses of foreign currency exposures, Mr Leslie Chang fell into a highly distressed state; as put by the psychiatrist, the result being that his ability to exercise his normal levels of judgement became severely impaired. This explains why those who attended the Sunday meeting, while they comprehended the broad outline of what he was attempting to explain, found much of it, especially in respect of detail, to be disjointed and confused. To that must be added the fact that, rightly or wrongly, those who attended the meeting were of the view that certain of the figures in the various analyses presented to them were inconsistent. Put bluntly, the senior financial officer of the Company, the person who should have been in a position to give a clear, comprehensive and fully rational presentation, was not in a position to do so.

Events Following the 'Sunday Meeting'

154. According to Mr Henry Fan, the 'task force' investigations that had been agreed at the Sunday meeting were essentially completed by 15 September 2008. During the intervening time, he said, he was wholly preoccupied with the investigations at hand and did not, therefore, reach out to obtain legal advice or to speak confidentially with the Stock Exchange.

155. However, on the 8 September 2008 – the day after the Sunday meeting – he said that he did himself consider the regulatory issues, specifically the requirement under section 13.09(1) of the Listing Rules that imposes a requirement on listed companies to keep shareholders informed as soon as 'reasonably practicable' of information that might reasonably be expected to materially affect market activity in its shares. The wording of the requirement appeared to give some rational leeway and, in light of the concerns of Mr Larry Yung that, if the news got out prematurely, they would be "squeezed" by the banks when they attempted to unwind their TRF contract positions, it was resolved to keep matters confidential.

156. On 16 September 2008, however, CITIC's in-house lawyer was asked to obtain legal advice from CITIC's solicitors as to whether or not it would be possible to withhold making any announcement until unwinding had been completed. The advice received from the solicitors was positive and, armed with that advice, it was decided that it was not necessary at that time to approach the Stock Exchange.

157. Mr Henry Fan said that, at this time, it simply never occurred to him to look back to the entirely routine Dah Chong Hong circular and the

‘no material adverse change’ statement contained in the annexure to that circular.

158. On the Monday, 8 September 2008, Mr Larry Yung gave instructions to Mr Albert Tam (who had been at the Sunday meeting) to commence a prudent termination of Australian dollar TRF contracts if that was possible. He further reached out to his contacts in Beijing to see what support could be given. This resulted in a number of meetings on the 10, 11 and 12 September 2008 in which Mr Larry Yung attempted unsuccessfully to novate the TRF contracts. However, he was able to obtain pledges of financial support. For example, on 11 September 2008, he secured a loan of RMB15 billion from the Agricultural Bank of China and was able to dispose of an office building to the bank for RMB5 billion and on the following day was able to secure a further loan of US$1 billion from the China Development Bank.

159. In his witness statement, Mr Larry Yung said that he was working against a chaotic backdrop at the time because of the increasing global financial crisis. As he put it in his witness statement “my only concern at the time was to resolve the TRF problem and to stabilise the operations of and protect CITIC so that it could sail through and survive the financial tsunami. I did not think about and did not connect the Dah Chong Hong circular with the TRF issue.”

The Task Force Meeting on 15 September 2008

160. As to the clarification of CITIC’s position of exposure, Mr Larry Yung said that the extent of the potential losses was only clarified on 15 September 2008 when calculations of values provided by counterparty

banks showed that the mark-to-market loss at that moment in time was "approximately HK$6 billion, and the total amount involved in all the TRF contracts was some AUD$11 billion".

The Cash Flow Analysis

161. In the days following the Sunday meeting, as part of the work of the task force, CITIC's Business Development Department prepared a detailed cash flow analysis. The work was overseen by Mr Steve Kwok, an Executive Director who was responsible for the working of that Department and was co-opted onto the task force after 7 September 2008. The analysis was presented at the task force meeting held on 15 September 2008.

162. The essential purpose of the cash flow analysis was to test whether it was within CITIC's ability to cope with the extensive over-hedging, that is, whether it had sufficient liquidity to manage the cash flow stress arising from the obligation under the TRF contracts to take leveraged monthly delivery of Australian dollars and to do so over the balance of the contracts: some 20 months or more. In the course of his evidence, Mr Kwok said that, on a study of the cash flow analysis, it was clear that CITIC had sufficient assets and business operations to act as a buffer against the anticipated losses. In short, the problem could be managed.

163. The analysis assumed that the Australian dollars would be purchased under each TRF contract at the given strike rates strike and that they would then be sold back into the market at certain assumed rates that fell within a feasible range at that moment in time.[22]

[22] By way of illustration, at a spot rate of 0.82 (US$0.82 equalling AUD$1) in the month of April 2009 the analysis showed that there would be a loss of US$18.87 million. In this month, the TRF contracts

164. Mr Steve Kwok agreed that if the Australian dollars that had to be received each month were not sold back into the market but, for example, were, for a period of time, used to meet the costs of construction of the Sino Iron Project or the cost of the operation of the project after construction, then there would be no cash flow loss for that period. He further agreed that if the Australian dollars were not sold back into the market but were held pending a return to a better Australian dollar/US dollar exchange rate (i.e. a rebound) no loss would be realised.

165. As Mr Steve Kwok put it in the course of his testimony:

> " … to add up all the 20 plus months, the aggregate of the losses that we calculated were in the range of HK$4 billion to HK$5 billion. However, this loss would be spread over the course of two years as far as cash flow was concerned, if indeed the Australian dollar was at such a spot rate, and then we would incur such a loss. However, in the next two years, there could definitely be a lot of different things happening, foreign exchange fluctuations being one, and, secondly, even if the loss amounted to HK$4 billion or HK$5billion, we did have the room, the time, the assets and business to [act as a] buffer for such loss."

166. Mr Steve Kwok testified that, as he remembered it, when the cash flow analysis was presented to the task force at the meeting on 15 September 2008, nobody at the meeting felt that this represented "a very significant loss in profits". This was more especially the case, he commented, when at the time the task force was looking to a number of measures to alleviate the drain on resources. The cash flow analysis, he said, revealed that CITIC

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would require delivery of AUD$348 million at a cost of US$304.23 million at an average strike rate of US$0.87422 less the amount retrieved by selling back to the market at the rate of 0.82.

clearly had the ability to deal with the deliverables arising out of the over-hedging. Yes, there was a problem but, as the Tribunal understood the gist of his evidence, it was to the effect that the cash flow stress could be managed through the balance of 2008 and also 2009 – for the next 18 months - by which time, it was anticipated, some rationality would have returned to the currency markets. By way of summary, therefore, nobody at the meeting held on 15 September 2008 believed that the leveraged deliverables arising out of the over-hedging constituted *at that time* an undermining of CITIC's financial integrity.

167. Mr Steve Kwok accepted, of course, that in the following weeks, that is, in October 2008, the Australian dollar/US dollar exchange rate dropped very significantly, making the situation a lot worse than had been anticipated when the cash flow analysis was presented on 15 September 2008.

168. One other matter that arose at the meeting of the task force held on 15 September 2008 was confirmation that the TRF contracts would not qualify as hedging instruments and that accordingly the mark-to-market losses - if realised - would have to be accounted for in the profit and loss accounts when they fell due for publication.

Why Was No Action Taken to Amend the Dah Chong Hong Circular or Hold Back Its Publication?

169. In terms of the responsibility statement, each specified person had undertaken responsibility for the accuracy of the information appearing in the Dah Chong Hong circular. In his closing submissions, Mr Bell, the Presenting Officer, commented that "guarantees" of this type given to the

investing public "must mean what they say for Hong Kong to maintain its reputation as one of the top financial markets in the world".

170. There is no doubt that the Company Secretarial Department of CITIC, which reported directly to Mr Henry Fan, had tried and tested procedures in place to ensure that, when announcements were published and when subsequent circulars were uplifted to the Stock Exchange website, they were accurate.

171. On this occasion, however, the information of CITIC's exposure to foreign currency risk through the TRF contracts and the fact that the true nature and extent of that exposure was being investigated was kept confidential, contained within a small circle consisting of Mr Larry Yung, Mr Henry Fan, Mr C.Y. Chau, Mr Peter Lee, Mr Albert Tam and those few other employees of CITIC with whom they had to work in order to conduct their investigations.

172. As to the need to keep matters confidential, in his witness statement Mr Larry Yung said the following:

> "At the time, Henry Fan told me that this matter was highly sensitive and that we should limit the number of people within CITIC Pacific who would be told of it. We also agreed that I would work on unwinding the TRFs and look into the possibility to novate them to third parties and liaise with banks on financing to improve the financial stability and resolve the issue of cash flow of CITIC Pacific, while Mr Henry Fan would take charge of the day-to-day operations, as well as all the legal matters as he had always done. "

173. Mr Henry Fan's recollection was slightly different but this is not a matter of any consequence. What matters is that an agreement was reached at the Sunday meeting that, because of the highly sensitive nature of what was being investigated, the nature and extent of the investigation would be kept confidential. That decision meant that there was no communication with Ms Stella Chan, the Company Secretary, or Mr Alan Lee, the Assistant Director of the Financial Control Department and the person responsible for reviewing draft circulars.

174. In his closing submissions, Mr Bell said that it was the deliberate decision of the specified persons to keep the matter of CITIC's TRF contract crisis confidential and it was *this* decision which had prevented a previously well tried system from functioning successfully.

175. In the result, the following was the history of how the circular came to be published:

(i) On 5 September 2008, in accordance with standard practice, Ms Stella Chan sent a batch of documents to Mr Henry Fan for his approval. The documents included a board resolution authorising publication of the Dah Chong Hong circular, a directors' responsibility letter and the opinion of the independent financial advisor;

(ii) After Mr Henry Fan had approved the documents and signed, they were circulated to the other specified persons. Mr Larry Yung, in accordance with standard practice, received a short note in Chinese explaining the nature of the documents together with the original of the board resolution that had now been signed by Mr Henry Fan: evidence, of course, that the proposed publication had met with his approval. Mr Larry Yung signed because, as in the past, he relied on that approval;

(iii) All of the specified persons signed the relevant documents;

(iv) On the evening of 8 September 2008, the Stock Exchange completed its review. The independent financial advisor confirmed that it had no further comments and, as a final checking measure, Ms Stella Chan emailed Mr Alan Lee;

(v) In a brief exchange of communications, Ms Stella Chan asked Mr Alan Lee to focus on two sections in the draft circular, one of them being the 'no material adverse change' statement. An hour or so later, Mr Alan Lee replied that he had no comment; and

(vi) In the result, after close of trading on 12 September 2008, the circular was uploaded to the Stock Exchange website.

176. Mr Alan Lee, with no indication given to him, had no reason – in respect of an entirely mundane circular - to make special enquiries of Mr Henry Fan, the Managing Director, while Mr Henry Fan, consumed as he was with attempting to assess the nature and extent of CITIC's foreign currency exposure, had clearly not believed it necessary, in the interests of keeping matters confidential until the assessment had been completed, of confiding in his Company Secretary or Mr Alan Lee.

177. What then of independent memory? The overall tenor of the evidence given by the specified persons was that the overwhelming importance of the matters that they were required to investigate as members of the task force meant that they simply never turned their minds back to what was considered to be an unimportant and routine circular that they had authorized a few days earlier.

178. Mr Henry Fan, in the course of his evidence, did accept that, with the benefit of hindsight, if he had at the time cast his mind back to the impending publication of the Dah Chong Hong circular –

> " … I would have rung up the Company Secretary, asked her to withhold the circular, seek an extension from the Stock Exchange of the deadline, and sought professional advice on the way forward. That's what I would have done."

CHAPTER THREE

DIRECTIONS AS TO LAW

179. In respect of the first three essential elements of section 277(1) of the Ordinance, the Tribunal has come to certain specific determinations of law which are set out later in this report. At this juncture, however, the following more general directions of law are given.

The Burden of Proof and Standard of Proof

180. The SFC bore the burden of proof. No such burden rested on the specified persons. In respect of the standard of proof, section 252(7) of the Ordinance provides that:

> " … the standard of proof required to determine any question or issue before the Tribunal shall be the standard of proof applicable to civil proceedings in a court of law."

181. That standard is the balance of probabilities which has been expressed as follows:

> "The balance of probability standard means that a court is satisfied an event occurred if the court considers that, on the evidence, the occurrence of the event was more likely than not."[23]

[23] See *Solicitor (24/7) v The Law Society of Hong Kong* (2008) 11 HKCFAR 117.

Good character

182. Market misconduct, though not criminal in nature, is a serious finding against an individual. In this enquiry, each of the six specified persons were persons of unblemished professional background and were persons of good character. Accordingly, the Tribunal has recognised that they were less likely than otherwise might be the case to have committed the alleged misconduct.

The Dangers of Hindsight

183. During the course of the enquiry it was submitted by a number of counsel representing the specified persons that, when examined closely, the core of the SFC's case was very much based on the 'exact science' of hindsight. Whether that was or was not the case, the Tribunal has warned itself of the dangers of judging the actions of the specified persons through the prism of hindsight.

184. In this regard, the Tribunal has taken into account the following observations of Megarry J[24]:

> "In this world there are few things that could not have been better done if done with hindsight. The advantages of hindsight include the benefit of having a sufficient indication of which of the many factors present are important and which are unimportant. But hindsight is no touchstone of negligence. The standard of care to be expected of a professional man must be based on events as they occur, in prospect and not in retrospect."

[24] See *Duchess of Argyll v Beuselinck* [1972] 2 Lloyd's Rep 172, a case involving allegations of negligence by a solicitor

The Drawing of Inferences

185. In so far as it has been necessary for the Tribunal to come to any determination by way of drawing inferences, the Tribunal has directed itself that any conclusions reached must be plainly established as a matter of inference from proved facts. The proceedings being civil in nature, it would not be right to say that the requisite standard prescribes that the inference is to be the only inference that can be drawn, that being the standard which applies to criminal matters. However, an inference must be established as a compelling inference.

Expert Evidence

186. In the presentation of its case, the SFC relied upon the expert testimony of two witnesses. They were, first, Mr Stella Fung Sau Hong, the holder of a Master's degree in finance and a chartered financial analyst, and, second, Mr Richard Harris, a professional expert witness in matters of finance.

187. The Tribunal received the evidence of both witnesses, both as to the information given by them and the expressions of opinion made by them, because it was likely to be outside the experience and knowledge of the Tribunal members. The evidence, however, was received on the basis that the Tribunal was entitled to accept or reject all or part of that evidence.

188. As to the legal principles governing the admissibility of expert evidence in civil proceedings – the proceedings which are the subject of this report being civil in nature - the focus must be on the assistance that such

evidence can provide to the Tribunal. In this regard, in *Barings PLC v Coopers & Lybrand (No 2)*[25], at para 45, it was observed that:

> "Expert evidence is admissible… in any case where the court accepts there exists a recognised expertise governed by recognised standards and rules of conduct capable of influencing the court's decision on any of the issues which it has to decide and the witness to be called satisfies the court that he has a sufficient familiarity with and knowledge of the expertise in question to render his opinion potentially of value in resolving any of those issues."

189. In the present case, in the judgment of the Tribunal, it is regrettable that the two experts called by the SFC, their general expertise being accepted, nevertheless appeared in this instance to be giving evidence on matters outside of their specialised areas of knowledge.

190. In consequence, the fact that the Presenting Officer, in his final submissions, placed very little reliance on the evidence of either of the two experts was unsurprising.

191. The Tribunal itself has been unable to place any substantial reliance on the evidence presented by the two witnesses. In this regard, an authority placed before the tribunal by leading counsel for Mr Leslie Chang, Mr Charles Manzoni SC, was found to be of assistance. The authority is that of *Fu Kor Kuen Patrick v HKSAR*[26], the judgment being by Gleeson NPJ (at para 51):

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[25] [2001] Lloyds Report Bank 85.

[26] (2012) 15 HKCFAR 524

“The propensity of some expert witnesses to express opinions not wholly or substantially based on their specialised knowledge, but based upon inferences of fact outside their field of particular training or experience is well understood. The danger for the proper process of fact-finding at civil or criminal trials is obvious… An opinion, resting upon transparent factual assumptions, based upon a branch of knowledge in which the witness is an expert, may be of legitimate assistance to a finder of fact. It is when a witness goes beyond those bounds and expresses a judgment on a matter outside his area of specialised knowledge that the danger arises.”

CHAPTER FOUR

HAVE THE FIRST TWO ESSENTIAL ELEMENTS OF SECTION 277(1) BEEN PROVED?

The First Essential Element: 'the Publication Element'

192. Within the context of this enquiry, the first essential element that fell to be demonstrated was that each specified person, being a director, had authorised, or in some other way had been concerned in, the publication of the Dah Chong Hong circular containing the 'no material adverse change' statement.

193. As stated earlier in this report, it was on 5 September 2008 that CITIC's Company Secretary, Ms Stella Chan sent out a memorandum to the directors on the CITIC board requesting them to consider and, if thought fit, approve the Dah Chong Hong circular. Attached to the memorandum were three documents, first, the board resolution approving the Dah Chong Hong circular to be signed by the directors; second, a copy of the draft circular and, third, a responsibility letter.

194. The responsibility letter, reflected in the circular itself, stated that each director –

> "… individually and together with the other directors of the Company accepts full responsibility for the accuracy of the information contained in the approved documents."

195. The memorandum reminded the directors that, for the purpose of any amendments and the like, the latest practicable date prior to the printing of the circular was 9 September 2008.

196. All the directors to whom the memorandum was addressed signed and returned the relevant documents.[27]

197. In light of this uncontested evidence, it was not disputed that each of the specified persons in their capacity as directors had authorised the publication of the circular.

The Second Essential Element: 'the Market Effect Element'

198. Within the context of this enquiry, the second essential element that fell to be demonstrated was that the information contained in the Dah Chong Hong circular, more specifically, the 'no material adverse change' statement, was 'likely' to 'maintain, increase, reduce or stabilize the price of securities', that is, of CITIC securities.

199. All of the specified persons submitted that there had been a failure by the SFC to prove this second essential element. The issue, therefore, fell for determination.

200. As to the use of the word 'likely' in the section, the Tribunal has determined in a number of past reports that 'likely' means 'probable' and not merely 'possible'. In the course of his submissions, Mr Yu SC, leading counsel for Mr Larry Yung, summed up the test in the following words: 'it

[27] Mr Leslie Chang, Mr Henry Fan, Mr Larry Yung and Mr C.Y. Chau signed on 5 September 2008; Mr Peter Lee signed on 7 September 2008.

takes more than seeing a possibility, it requires finding a real degree of probability". As an instructive guide, the Tribunal agrees with that wording.

201. The second essential element of section 277(1) of the Ordinance therefore requires the determination of a predictive test, the test being an objective one. The Tribunal is required to ask itself not whether it was merely possible that the 'no material adverse change' statement would have had an effect on the market sufficient to influence the price of CITIC securities but is instead required to ask itself whether there was a real degree of probability that it would have had such an effect.

202. As the Tribunal has observed in an earlier report, the essential mischief that section 277(1) of the Ordinance seeks to avoid is not of itself the publication of false or misleading information about a listed company by a person who knows or is reckless or negligent as to that fact. The mischief lies in the fact that it is probable that such information would have a causative effect in that it would induce the investing public to deal in securities of the listed company and thereby undermine and/or distort the open and honest workings of the market. Mr Bell, the Presenting Officer, accepted the force of the observation when, in the course of his submissions, he accepted that "the clear statutory intention is to regulate conduct which has an effect on investor behaviour and thus the price of securities, whether that effect is to increase, reduce, stabilise or maintain the share price." In short, he accepted that there must be a probability of market effect.

203. It is for this reason that not all disseminated information about the market falls within the reach of section 277(1) of the Ordinance. It only falls within the reach of the section when, on a consideration of all relevant

evidence, it is found to be probable that it would be causative of the effects set out in sub-paragraphs (a), (b) and (c) of the section.

204. Mr Bell submitted that it is not necessary for it to be demonstrated to be the sole influencing factor, and that, of course, must be correct. In respect of the price of any regularly traded share, on any trading day there may be a number of factors influencing price. But that is not to diminish the Tribunal's interpretation just given. Accordingly, whether alone or in conjunction with other information, it must be probable that the information which is the subject of the enquiry would of itself have an effect on the market.

205. In his opening submissions, Mr Bell said that reliance would be placed on the two expert witnesses, Ms Stella Fung and Mr Richard Harris, to prove this second essential element. In his closing submissions, Mr Bell did not seek to place such reliance on their evidence and, in the view of the Tribunal, this was for good reason.

206. In their written reports and in the course of their evidence both Ms Stella Fung and Mr Richard Harris said that, in their opinions, the 'no material adverse change' statement had the effect of maintaining or stabilising the share price of CITIC on or around the date of publication, that is, on or around 12 September 2008. However, they did not base this on any noticeable movements in the price of CITIC securities at the time or on the fact that there was commentary by professional analysts and/or in the broader press. Put simply, as the Tribunal understood it, their approach to the issue may be summed up as follows. While the statement that was disseminated to the market may have had no influence upon it one way or the other, if the true nature and extent of the TRF contract prices had been

known at that time, *that* information would undoubtedly have had a marked influence on the price of CITIC securities. On this basis, the proposition was advanced that the failure to put the true position into the statement had falsely reassured the market and, to use the words of Ms Stella Fung:

> "As a result, CITIC's share price was maintained at a level higher than it should be …"

207. Mr Richard Harris, in his report, supported this approach. He said:

> "The market had no indication of the size of the unrealised losses from the foreign exchange contracts until the profit warning. The statement encouraged the impression of a company where nothing was amiss."

208. Mr Richard Harris continued:

> "This assumption of stability would have been reinforced by the relative lack of news about the Company while the global financial crisis was developing …"

209. In the result, said Mr Richard Harris–

> "… non-disclosure of the information [the information of the exposure to foreign exchange risk through the TRF contracts] meant that the share price was maintained and stabilized for a longer period than might have been expected."

210. In the judgment of the Tribunal, as a matter of statutory interpretation, this joint approach by the two expert witnesses (who, of course, did not purport to be experts as to law) was misconceived. The

second essential element of section 277(1) of the Ordinance requires that it is the information that is actually published that must be likely, that is, probable, to maintain, increase, reduce or stabilise the price of securities. It is not the information that should have been published. The information that should have been published - the information proving falsehood - is the subject of the third essential element of culpability under section 277(1) of the Ordinance.

211. Concerning the maintenance, increase, reduction or stabilisation of the price of securities - this being the core issue of the enquiry – the Tribunal is satisfied that, on a purposive construction, culpability under section 277(1) of the Ordinance arises when, in Hong Kong or elsewhere, a person disseminates, or is involved in the dissemination of information provided, first, that *this* information - the information that is disseminated - is likely to have the effect of maintaining, increasing, reducing or stabilising the price of securities.

212. What must thereafter be proved as a further and separate essential element of culpability is that the information that has been published is false or misleading as to a material fact, or is false or misleading by the omission of a material fact.

213. The separation of the second and third essential elements serves an important purpose. Regulatory culpability must be defined by rational limits. Information is the life blood of any financial market. On any trading day in Hong Kong - Hong Kong being one of the world's busiest markets - no doubt thousands of communications take place, all containing information that is directly or indirectly relevant to the market. In the greater scheme of things the great majority of those communications are entirely insignificant

in the sense that they will have no influence on the market nor will they induce others to deal in securities. These communications, even if, upon examination, they are found to be false or misleading as to some material fact, do not fall within the ambit of section 277(1) of the Ordinance. If, however, a communication is made containing information that is likely to have an influence on the market or to induce others to deal in securities[28], then the authors of that communication are legitimately put on their guard to ensure that the information is not false or misleading as to some material fact. In the judgment of the Tribunal, the architecture of section 277(1) of the Ordinance makes it plain that this is the manner in which the legislature chose to draw the necessary rational limits.

214. In his final submissions, Mr Bell limited his arguments to the statutory interpretation of the second essential element that accords with the Tribunal's interpretation just given, namely, that the burden rested on the SFC to demonstrate that the information actually published by CITIC would – of itself – have been likely to have a market effect. Mr Bell did not argue that the 'no material adverse change' statement was likely to have increased the price of CITIC securities. It was instead his submissions that it would likely have had the effect of 'maintaining' the price of those securities. Without any evidence of actual reaction to the publication of that statement on or about 12 September 2008, his submissions were broad in nature. As he expressed it, the 'no material adverse change' statement was issued at a time when world markets – including the Hong Kong market - were volatile, when there were increasing concerns as to the reach of a developing global financial crisis. In those circumstances, a statement by CITIC that its directors were not aware, that is, had no knowledge of, any material adverse

[28] This refers to sub-sections (a) and (b) of section 277(1).

change in the financial position of the Company would have assured the market and thereby 'maintained' the share price. The statement, he said, was effectively the giving of a clean bill of health that would have assured the market that it was 'business as usual'.

215. Of importance, Mr Bell did not submit that the 'no material adverse change' statement would likely have had an influence by way of 'maintaining' and/or 'stabilising' CITIC's share price. He did not place any reliance on the concept of stabilisation. This was despite the fact that Mr Richard Harris, when giving his evidence as an expert, had said that "for this case" he had looked to the dual concepts of maintaining and stabilising.[29] On the basis of Mr Bell's submissions, therefore, the 'no material adverse change' statement would in all probability have acted to maintain the price of CITIC securities simply by keeping it at or about a certain level, there being no requirement to assume the existence of "any background rising or falling tendency". As Mr Bell put it, there is no sensible or logical reason why there has to be a trend of rising or falling for a share price to be 'maintained' so long as the investor relies upon the false or misleading information for his investment decision.

216. Mr Bell said that direct evidence of the effect on investors was not necessary. An assurance of the financial position of CITIC would obviously have been relevant to the making of investment decisions at or about that time, more especially in light of the increasing global turbulence. There was no warrant to surmise, he argued, that the 'no material adverse change'

[29] In this regard, the following exchange took place between Mr Yu, counsel for Mr Larry Yung and Mr Richard Harris:

"Q: Your understanding of maintaining or stabilizing, because you group them together, you treat them as more or less synonymous, is that right?

A: For this case, yes."

statement, although published, was never read. Adopting the evidence of Ms Stella Fung, he said that in the market there are always people who read every announcement and analyse every announcement; it would have been surprising in the extreme if nobody had read the Dah Chong Hong circular and digested it. The fact that the circular said only that it was 'business as usual' - as important as that was - would have given no cause to comment.

217. Mr Bell urged the Tribunal to adopt a realistic and common sense approach. CITIC was at the relevant time, a blue chip stock with a daily turnover (from early September into October 2008) in the region of HK$60 million to HK$300 million. The likely investor demographic, he said, included large institutional investors as well as small retail investors. The markets at the time were jittery. Liquidity was tightening; the business environment was extremely difficult. It was in these extraordinary market circumstances, he said, that on 12 September 2008 CITIC issued its circular containing the assurance from the directors that, whatever the everyday challenges, they were not aware of any material adverse change in CITIC's financial position. Common sense dictated, he said, that the announcement made in these circumstances must have reassured the market and thereby must have been a material factor in maintaining the price of CITIC securities. In support of his submission that a realistic approach should be adopted, Mr Bell cited the Court of Appeal decision in *HKSAR v Du Jun*[30] in which it was said that often in cases of the kind before this Tribunal, there was much to commend the value of a common sense approach. While experts might put forward intricate analyses, on occasions these tended to obfuscate what in truth was not so complex, namely, the likely impact upon the ordinary reasonable investor.

[30] CACC 334/2009, para 107.

218. The Tribunal, of course, accepts the full force of what was said by the Court of Appeal. The Court of Appeal, however, was not laying down an approach to be adopted on all occasions. As the truism goes, context is everything. Put another way, there may often be occasions when a correct (and just) analysis is arrived at by adopting a common sense approach. But, that said, the primary function of all Tribunals is first to identify the evidence relevant to the issue before it, and to weigh that evidence in light of the applicable burden and standard of proof. In the present case, the burden at all times rested on the SFC to demonstrate on a balance of probabilities that it was likely, that is, probable, that the 'no material adverse change' statement would have had some form of influence on the price of CITIC securities, to induce dealing in those securities; in the present case, that influence being to maintain their price. The question to be answered by the Tribunal is whether, on the evidence put before it, that predictive test has been directly demonstrated to the required standard, or whether, on a consideration of all the evidence, an inference that it must have been the case has been established as a compelling inference.

219. In determining the issue, the Tribunal has borne in mind that information put into the public arena by a listed company that has no effect at all may be said to have 'maintained' that company's share price simply because of the fact that the total lack of effect has caused no movement at all. But, in the opinion of the Tribunal, that would not be sufficient to prove the second essential element of section 277(1) of the Ordinance; it would indeed be contrary to its purpose.

220. As indicated earlier, the issue falling for determination must be considered in context. In doing so, the Tribunal has looked to the Dah Chong Hong circular itself and, in that respect, to a number of observations

made by counsel for the specified persons. The observations may be summarised as follows:

(i) CITIC regularly published announcements. The announcement contained in the circular was not therefore something unusual, something which, by reason of the fact that it was rare, was to be given particular attention;

(ii) To this must be added the fact that the transaction described in the circular was mundane. It concerned the purchase of interests in two motor vehicle companies, not by CITIC itself, but by Dah Chong Hong, a non wholly-owned subsidiary and itself a listed company;

(iii) Details of the transaction had already been published in mid-August 2008, several weeks earlier, without raising any concern of any kind in the market. That was understandable considering that the total consideration of the transaction was a sum of HK$143.716 million (less than US$19 million), an amount in any event to be funded from the coffers of Dah Chong Hong and not CITIC;

(iv) Aside from the 'no material adverse change' statement (which appeared on page 43 of the circular) and certain other mundane and unsurprising details related to the CITIC, the circular posted on the Stock Exchange website on 12 September 2008 did not present anything new for the market to digest; and

(v) CITIC's financial involvement in the matter of the transaction to acquire the two motor vehicle companies, even when looked at indirectly, was essentially insignificant. In 2007, Dah Chong Hong was 56.6% owned by CITIC; it had net assets of HK$2,399 million. As Mr Duncan put it, the consideration ratio, assets ratio and profits ratio calculated by CITIC in accordance with the Listing Rules were all less than 1%. Even indirectly, therefore, the transaction was manifestly of no material significance to CITIC.

221. The Tribunal has, of course, taken into account that no doubt a number of professional analysts would have gone directly to the information in the Dah Chong Hong circular concerning CITIC itself, that is, to the 'no material adverse change' statement. But, as Mr Richard Harris himself observed, there had been no particular news concerning CITIC and, in the view of the Tribunal, no particular motivation, therefore, to discover whether there was a material change to the Company's financial position. Yes, the global financial crisis was being felt no doubt in almost all markets and by many companies trading in those markets; stress, no doubt would have been commonplace. But no evidence was put before the Tribunal to suggest that the market's attention would have been drawn particularly to an Asian trading conglomerate such as CITIC and that the 'material adverse change' statement would therefore have been likely to elicit a sense of assurance (or reassurance) sufficient to influence the price of CITIC shares by maintaining that price.

222. What of evidence of any market reaction to the publication of the circular? Ms Stella Fung said that she had made a search through newspaper

reports, analyst reports and the like to see if there had been any reaction to the Dah Chong Hong circular. She had found nothing. The following exchange confirmed this to be the case –

> "Chairman: You have said that one of the purposes [of the exercise] would have been to see if you could find positive evidence of the circular having been digested and acted upon. And would it be correct to say that you did not find positive evidence of the circular having been digested and acted upon?
>
> Ms Stella Fung: Yes."

223. What of evidence of any form of effect on the price of CITIC securities at or about the time of publication? The data concerning relevant share price movements can be found in the table attached to this report as Annexure D [31]. The table shows that on the first trading day after 12 September 2008, that being 16 September 2008, CITIC's share price fell 5%. The Hang Seng Index fell by almost the same percentage: some 5.4%. When she gave evidence, Ms Stella Fung said that she had studied the share price movements to find support for the contention that the 'no material adverse change' statement had maintained the share price but could find no significant effect one way or the other. As she put it, when the statement was published, there was no significant effect on the share price, meaning that it had not pulled down the share price or help to push it up. The following exchange then took place between herself and Mr Yu, counsel for Mr Larry Yung:

> "Mr Yu: Maybe because nobody read, right? Nobody read it or nobody relied on it. Correct?

[31] The table was presented to the Tribunal as an annexure to the expert report submitted by Ms Stella Fung.

Ms Stella Fung: It's possible and also possible is that people read it but think that it has no effect…"

224. In that answer, given in the context of inconclusive share price movements, the witness accepted that the 'no material adverse change' statement may have had "no effect", put another way, may not have had any impact on CITIC's share price one way or the other.

225. Shortly thereafter there was the following exchange with the Chairman:

"Chairman: Perhaps, would you agree with this: that there is no evidence that the share price immediately before this announcement was volatile and/or in a downward trajectory and that immediately after the publication of the notice, the share price levelled off and maintained itself at a particular price?

Ms Stella Fung: Yes. [meaning: I agree]"[32]

226. Mr Richard Harris, the other expert witness called by the Presenting Officer had embedded in his report a chart showing the relative share price performance of CITIC against the Hang Seng Index ('the HSI') between 1 June and 31 December 2008. In his report, immediately below the chart, he commented that it showed that "the share largely keeps pace with the index to about 6 October 2008 and then begins to underperform the HSI". In short, he accepted that in the weeks before the publication of the 'no material adverse change' statement on 12 September 2008 CITIC shares

[32] Counsel, Mr Yu, clarified the position with the witness immediately thereafter when he said that her answer suggested that she had attempted an exercise to find evidence of the kind suggested by the Chairman but had found no evidence. The witness agreed.

had largely kept pace with the HSI and had continued to do so for a least three weeks *after* publication.

227. In summary, the investigations of the two expert witnesses as to the influence of the 'no material adverse change' statement had revealed no evidence of influence at all or, at best, their investigations had been entirely inconclusive. The root cause appears to have lain in what the Tribunal considered to be their misconceived approach. As the Tribunal has said a little earlier, as to a lack of specific evidence both experts appear to have largely conceded that the statement that was disseminated to the market may have had no influence upon it one way or the other but, if the true nature and extent of the TRF contract exposures had been known, that, in their view, would undoubtedly have had an effect on share prices.

228. In fairness to Mr Richard Harris, he did assert that, having regard to the global volatility at the time, the 'no material adverse change' statement would have assured the market, maintaining, or helping to maintain, the share price. But it was a general statement in answer to a question; with respect, in the absence of any supporting data, essentially speculative. Mr Richard Harris agreed in the course of his evidence that there had been no particular news concerning CITIC prior to the publication of the 'no material adverse change' statement and no particular reason, therefore, to be looking for any form of assurance that all was well.

229. What then of a test employing a realistic and commonsense approach as urged by Mr Bell? The difficulty with that is that, other than the fact of an increasing global financial crisis having the potential to place stress on all listed companies in all markets, nothing was placed before the Tribunal to suggest that CITIC, or companies like CITIC, were at that time

under particular scrutiny by the market. Nor was there evidence of any particular volatility in CITIC's share price in the days or weeks leading up to the publication of the announcement which settled, in the sense of stabilising, after the publication.

230. On the basis of Mr Bell's submissions, of course, it was not necessary to show any positive or negative reaction. In citing the Collins Cobuild English Dictionary, Mr Bell said that 'if you maintain something at a particular rate or level, you keep it at that rate or level." The Tribunal, however, is satisfied that the concept of to 'maintain' is nevertheless causative. In this regard, the New Shorter English Dictionary (4th Ed) states that to 'maintain' means "to cause to continue" in so far as that may apply to a state of affairs or a condition.

231. In his submissions, Mr Yu said that, if causation is required to be identified, invariably the concept of 'maintaining' the price of a security must be understood as counter-acting a tendency to volatility. In that sense, it was said, the concept is close to, and often used in conjunction with, the concept of stabilizing a share price. By way of illustration, in *Australian Securities and Investments Commission v MacDonald and Others (No. 11)* [33], a company facing damages claims for asbestos related diseases made an announcement that there were sufficient funds to meet all legitimate claims. The announcement was false but was intended to achieve a positive reaction from the market. The Court of Appeal (the Supreme Court of New South Wales) [34] held that the likely result was to induce readers of the announcement to continue holding the shares, adopting a wait-and-see attitude, and thereby "maintaining or stabilising their market price".

[33] (2009) 256 ALR 199

[34] The judgment given by Gzell J

232. In the same judgment, the court underscored that if there was no material impact on the price of a share that of itself could not amount to 'maintaining' its price. Some form of causation was required. By way of illustration, when dealing with representations made by the company to a small group of professional financiers, the court came to the following determination:

> "As to the Edinburgh representations, however, I am not satisfied that the statements made by Mr McDonald to an audience of three analysts, institutional investors, or fund managers, was likely to have the effect Mr Humphris [an expert witness] placed upon them. And none of them, in fact, was induced to recommend the purchase of [the] shares. *The absence of any purchase means that there could be, in fact, no maintaining or stabilising effect on the market.*" {emphasis added}

233. There can of course be occasions when it is not possible to identify any specific form of causation but nevertheless to be satisfied that, having regard to all the relevant evidence, the inference to be drawn is that a share price has been maintained. As said earlier, however, for such an inference to be drawn, it must be a compelling inference and the Tribunal has been unable to draw an inference of that force – or anything even approaching that force – from the evidence presented to it.

234. Why would there be such a lack of evidence? In the opinion of the Tribunal, one such factor could well have been the existing assumption of CITIC's stability already apparent in the market: this being a factor identified by Mr Richard Harris in his report. As he said: "the assumption of stability would have been reinforced by the relative lack of news about the

Company while the global financial crisis was developing …”. There was no evidence, therefore, upon which to draw the inference that the market - ordinary reasonable investors - were waiting on some assurance that setbacks already identified would not materially affect CITIC’s financial or trading position. Put simply, there was no particular reason, in respect of CITIC, to be looking for assurance (or reassurance). This is to be contrasted with the position in *Australian Securities and Investments Commission v MacDonald and Others* where the public was already aware that the company was facing damages claims for asbestos related diseases and where an assurance as to the financial stability of the company would have been hoped for.

235. One further matter was raised during the course of submissions as to why the Dah Chong Hong circular, and more particularly, the ‘no material adverse change’ statement contained in the circular, would not have attracted any particular interest. That is because, as mentioned in the first chapter of this report, section 13.09(1) of the Listing Rules imposes a requirement on listed companies to keep shareholders informed as soon as reasonably practicable of information that might reasonably be expected to materially affect share price. The section - under the heading of ‘general obligation of disclosure’ - reads:

> “Generally and apart from compliance with all the specific requirements of this Chapter, an issuer shall keep the Exchange, members of the issuer and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new development in the group’s sphere of activity which is not public knowledge) which:

a) is necessary to enable them and the public to appraise the position of the group; or

b) is necessary to avoid the establishment of a false market in its securities; or

c) might be reasonably expected materially to affect market activity in and the price of its securities."

236. Pausing, the Tribunal has taken note of the fact that 13.09(1) and 14.08 of the Listing Rules deal with different areas of communication. The provisions of 13.09(1) of the Listing Rules require a company to keep shareholders informed of what is commonly called 'price sensitive' information while 14.08 of the Listing Rules imposes a different requirement, one that – for reasons to be explored later in this report – looks to a far more significant and enduring impact on the financial integrity of a company, that more rigorous test being contained in the chosen words: 'no material adverse change in the financial position' of a company.

237. Against this background, the following exchange took place during the course of Mr Richard Harris' testimony:

"Mr Yu: One reason that you have given [for the 'no material adverse change' statement maintaining and/or stablizing the share price] is because the no material adverse change statement gives the impression that business is as usual. Is that right?

A: I believe so.

Mr Yu: But what I want to put to you is that, even without a material adverse change statement, even if the company had not issued a

> circular, wouldn't investors be entitled to expect, because of section 13.09 that, if there is something which materially affects the share price which the company knows about, the company would have published it?
>
> A: Yes.
>
> Mr Yu: Therefore, the no material adverse change statement doesn't actually add anything to the pool of information that the investors would have, because the investors would already be assuming business as usual unless something is published; is that right?
>
> A: That's correct."

238. Ms Stella Fung, the other expert witness, was informed by Mr Yu of this exchange and asked if she concurred with the answers given by Mr Richard Harris. She said that she did.

239. In the judgment of the Tribunal, due weight can be given to Mr Yu's submissions in this regard and the complementary concessions made by both expert witnesses.

The Tribunal's Conclusions as to the Second Essential Element

240. For the reasons given, in light of the complete absence of evidence as to any actual influence occasioned by the publication of the 'no material adverse change' statement on the market at or about the time of the statement's publication and in light of the almost complete absence of primary evidence upon which to draw inferences, the Tribunal has been drawn to the conclusion that it has not been demonstrated that the 'no material adverse change' statement had any influence on the market, that is,

on the actions of ordinary reasonable investors so as to maintain (or stabilise) the price of CITIC securities.[35]

241. The Tribunal recognises, of course, that the test to be applied by it in respect of the second essential element of section 277(1) of the Ordinance is a predictive one, the question to be asked not being whether evidence has been presented of any influence but whether at the time of publication it was probable that there would have been an effect sufficient to maintain the price of CITIC's securities. The Tribunal recognises that there is a real difference not merely a semantic one. By way of example, there may be a real degree of probability that information at the time of publication will have an effect on the market so as to maintain, increase, reduce or stabilize the price of securities but, by reason of some major intervening event, does not do so.

242. In the judgment of the Tribunal, however, the question of likelihood cannot be answered in the abstract; it must, where possible, be answered by having reference to specific facts, or the lack of them, and relevant circumstances. In *Tillmanns Butcheries Pty Limited v Australian Meat Industry Employee's Union*[36], Deane J held (at paras 381-382) that:

> "… If conduct had run its ordinary course and had not had the specified effect, it would be but rarely that a court would feel justified

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[35] In reaching its conclusions, the Tribunal has not been ignorant of what is known as the 'efficient market hypothesis', namely, that it is to be assumed that stock markets are informationally efficient in the sense that all publicly available information will be absorbed and processed. On this basis, it is to be assumed that the Hong Kong market, being an efficient market, will have processed all relevant information including the 'no material adverse change' statement and that accordingly, if there was no affect on the share price, the reason must lie in the fact that, the information being essentially one of 'business as usual', that neutrality maintained the share price. That said, in reaching its conclusions, the Tribunal has had to do so in accordance with binding legal principle and not economic hypotheses, no matter how well established and well-respected. There may, of course, be occasions when economic hypotheses support findings of fact or of law but, in the view of the Tribunal, this is not such an occasion.

[36] (1979) 27 ALR 367

> in disregarding the lesson of the event and finding that while the conduct did not have the specified effect it had been more likely than not that it would have had that effect."

243. To same effect, in *Australian Securities and Investments Commission v Macdonald (No 11*[37]*)* (at para 1067) it was said:

> "… where likelihood of the occurrence of an event is in issue and relevant facts are available, they are to be preferred to prophecies."

244. In light of these authorities, having regard to all relevant evidence, the Tribunal has been drawn to the conclusion that it is not been demonstrated that it was probable at or about the time of the publication of the 'no material adverse change' statement that it would have had the effect of maintaining (or stabilising) the price of CITIC securities.

245. In all the circumstances, for the reasons given, the Tribunal has been drawn to the conclusion that the there has been a failure to prove the second essential element of section 277(1) of the Ordinance. That failure has equal application in respect of each of the specified persons and means that each of them must be found not culpable of market misconduct.

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[37] Cited earlier: see .

CHAPTER FIVE

HAS THE THIRD ESSENTIAL ELEMENT OF SECTION 277(1) BEEN PROVED?

246. The third essential element that fell to be demonstrated by the SFC was that the information contained in the no 'material adverse change' statement was false or misleading as to a material fact or was false or misleading through the omission of a material fact and that the specified persons were aware of this fact as at 9 September 2008.

247. As with the second essential element, all of the specified persons submitted that there had been a failure by the SFC to prove this third essential element to the required standard. Accordingly, this issue also fell for determination.

248. To cite it again, the no 'material adverse change' statement read as follows:

> "Save as disclosed in this Circular, the directors are not aware of any material adverse change in the financial … position of the Group since 31 December 2007, the date to which the latest published audited accounts of the Company were made up."

249. The SFC case, as contained in paragraph 7 of its Notice, was as follows:

> "As at 9 September 2008 there was in fact a material adverse change in the financial position of CITIC arising from CITIC's position under the various TRF Contracts entered into by CITIC. The

> Statement was false or misleading as to a material fact or false or misleading through the omission of a material fact because as at 9 September 2008, the Specified Persons were aware of that material adverse change. This is clear from the Announcement, which provided that CITIC "*became aware of the exposure arising from [primarily the TRF Contracts] on 7 September 2008*", which is prior to the publication of the Circular and the "*Latest Practicable Date*" identified in the Circular."

250. For the avoidance of ambiguity, it does need to be re-emphasised that the announcement published by CITIC which provided that - on 7 September 2008, the date of the Sunday meeting - the Company had become aware of its exposure under the TRF contracts, was not accepted by the specified persons as amounting to any form of admission of awareness on that date of a 'material adverse change' in the financial position of the Group.

251. That being said, when looking to the matters to be proved, it was never disputed that, in order to demonstrate the third essential element, the SFC was required to demonstrate the following two matters:

(i) That, judged as an objective fact, there was in existence on 9 September 2008 a material adverse change in CITIC's financial position; not simply, therefore, a threatened or likely material adverse change but an actual change; and

(ii) that, as at that date, the directors of CITIC were aware that such a change had come into being.

Ms Stella Fung's Supporting Data

252. In the presentation of its case, the SFC placed reliance on the evidence of its two experts, the first being Ms Stella Fung, her statement being dated 7 November 2014, and the second being Mr Richard Harris, his expert opinion being dated 16 February 2015.

253. In her statement, Ms Stella Fung spoke of being instructed by the SFC that as at 9 September 2008, certain information had been available to CITIC. For ease of reference, this information was referred to by Ms Stella Fung as being contained in a number of tranches that she labelled 'Information A' through to 'Information F'. Each tranche referred to information available at a different period of time. This information was also relied upon by Mr Richard Harris.

254. Ms Stella Fung considered that the earliest data contained in 'Information A' and 'Information B' was not at the time material to CITIC's financial position. As she said, in respect of 'Information B' –

> " … it is difficult to conclude if this information, if it was made known to the investing public, would likely have an effect on CITIC's share price without knowledge on the strike rate that these Australian dollars were to be delivered. If the strike rate was below the prevailing spot rate, MTM [mark-to-market] gain would be recognised by CITIC from the deliverable Australian dollars. On the contrary, MTM loss would be recognised if the strike rate was higher than the prevailing spot rate. If the strike rate was at par to the spot rate, no MTM gain or loss would be recognised. Therefore, I am of the view that it might be premature to conclude that 'Information B'

would likely effect on CITIC's share price when it was made known to the public. "

255. What is to be noted in respect of this citation is that Ms Stella Fung was looking to the likely effect of relevant information on CITIC's share price if it was made known to the public. She was therefore focusing on likely market effect. This approach was subject to criticism by counsel representing the specified persons on the basis that it confused two separate and distinct concepts, namely, the concept of 'price sensitivity' and the concept of 'adverse material change in the financial position of a company'.

256. For reasons set out later in this chapter, the Tribunal is satisfied that the two concepts are to be distinguished and that Ms Stella Fung's expert evidence was deprived of much of its weight by conflating the two concepts.

257. Ms Stella Fung was of the opinion that the data contained in 'Information C' through to 'Information F' was material to CITIC's financial position. In this regard, in respect of each tranche of data, she said the following in her statement:

(i) Information C

Information C revealed that on 4 September 2008, the Scenario Analysis prepared by the Finance Department of CITIC showed that as at 29 August 2008, the MTM [mark-to-market] loss on AUD TRF, EUR TRF and DCTRF contracts amounted HK$3,170 million. The amount of the MTM loss was substantial as it represented 72.4% of

CITIC's net profit for the first six months of 2008, 29.2% of its net profit for the year of 2007, and 5.2% of its net asset value as at 30 June 2008. As disclosed in Information A, the MTM loss on TRF contracts was recognised in the Profit and Loss account of CITIC. Therefore, I am of the view that the MTM loss was very material to CITIC's financial position. Although such MTM loss was "unrealised" loss and might vary from time to time depending on the movements of the spot rates of AUD and EUR, the investing public might be very cautious on the stock due to the uncertain outlook amid the then volatile global financial markets. Moreover, the huge MTM loss indicated the speculative and impudent treasury management of CITIC, which contradicted with investors' perception of a conglomerate with prudent and quality management. Therefore, I am of the view that the share price of CITIC would likely be adjusted downward materially if Information C was made known to the investor public.[38]

(*ii*) *Information D*

According to Information D, the Scenario Analysis indicated that the weaker the spot rates of AUD and EUR, the larger the amount of the MTM loss and the amounts of AUD and EUR to be delivered. According to Bloomberg, on

[38] Here again Ms Stella Fung proffered her opinion as to 'materiality' in the context of the reaction of the investing public, her suggestion being that, although the mark-to-market loss was 'unrealised' and therefore open to fluctuation, the market would in all likelihood react cautiously; more than that, there may be a reaction based on perceptions of poor management. For reasons to be examined, the Tribunal is satisfied that these are quintessentially matters related to price sensitivity and not to 'material adverse change'.

4 September 2008, the spot rates of AUD and EUR were 0.8341 and 1.4471 respectively. Based on the Scenario Analysis, the estimated MTM loss would be between HK$4,600 million and HK$6,634 million, which represented 105% to 152% of CITIC's net profit for the first six months of 2008, 42% to 61% of its net profit for the whole year of 2007, and 7.5% to 10.9% of CITIC's net asset value as at 30 June 2008. Therefore, the MTM loss was very material to CITIC's financial position.

Moreover, based on the spot rates on 4 September 2008, the estimated amount of AUD to be delivered under the TRF and DCTRF contracts would be between AUD 6,705 million (approximately HK$43.6 billion) and AUD 7,713 million (approximately HK$50.2 billion). Assuming these amount of AUD would be delivered in the coming 24 months in equal instalment, CITIC had to purchase AUD 279 million to AUD 321 million (i.e. HK$1.82 billion to HK$2.09 billion) in each instalment. This would put tremendous pressure on CITIC's financial position as its total cash at bank as at 30 June 2008 was HK$10.7 billion, which was only sufficient for paying around 6 months of AUD to be delivered under the contracts. Market participants would infer that CITIC might encounter severe cash flow problem in fulfilling its obligation of purchasing the deliverable AUD. If CITIC decided to terminate the contracts, it would have immediately crystallised the MTM loss.

The huge amount of MTM loss and deliverable AUD under the TRF contracts would not only had substantial adverse impact on CITIC's financial results and cash flow position, it also unveiled the poor risk and treasury management of CITIC. The huge currency exposure of AUD arising from the TRF contracts indicated that the management of CITIC was betting on the movement of AUD instead of hedging its currency requirement. Investors would lose confidence in the management of CITIC, and would demand a lower share price to justify the higher risk in investing in the stock. As a result of the MTM loss and the huge exposure to AUD, the share price of CITIC is likely to be re-rated downward significantly when this information was released to the investing public.

(iii) Information E

Information E revealed that on 7 September 2008, information prepared by the Finance Department showed that as at 29 August 2008, the MTM loss arising from AUD TRF contracts alone was around HK$3.119 billion with spot reference of AUD at 0.8578. This figure was larger than the HK$2.838 billion MTM loss as disclosed in Information C on 4 September 2008. Given that Information E was available at a later date (7 September 2008), the figure of MTM loss should have been updated. As discussed in paragraph 48, I am of the view that Information C was material to the financial position of CITIC, and if it was made known to the investing public, would likely lead to a material decline in CITIC's share price. Information E had the similar content of Information C but with an even bigger MTM loss arising from the AUD TRF contracts. Therefore, I am of the view that Information E was also material to the financial position of CITIC, and would have the similar negative price impact to the share price of CITIC as Information C when it was made known to the investing public.

(iv) Information F

Information F disclosed that if the spot rates of AUD and EUR were 0.82 and 1.43 respectively, the purchase of AUD under the TRF contracts would result in a loss of USD 523,329,897 (approximately HK$4.08 billion). This figure was smaller than the HK$6.0 billion MTM loss as stated in Scenario Analysis in Information C at the same assumed AUD and EUR spot rates. However, the figures in Information F were not MTM figures, but were projected profit or loss arising from the TRF contracts on a monthly basis up to October 2010, assuming the spot rates of AUD and EUR remained unchanged at 0.82 and 1.43 respectively throughout the whole period.

Information F revealed the project gain from AUD TRF contracts for the four months from September to December 2008 was USD 13.58 million (or HK$105.9 million), but the projected losses in 2009 and 2010 would be USD 224.4 million (or HK$1,750 million) and USD 312.5 million (or

HK$2,438 million). Comparing with the net profit of HK$10.84 billion recorded by CITIC in 2007, the projected losses in 2009 and 2010 due to the AUD TRF contracts were very material to the financial position of CITIC.

Moreover, according to Bloomberg, the spot rates of AUD and EUR on 5 September 2008 (Friday) were 0.8081 and 1.4207 respectively, which were even lower than the assumed spot rates in Information F in calculating the loss. As a result, the loss to be incurred by CITIC would even be larger than USD 523 million. I am of the view that if Information F was made known to the investing public, the share price of CITIC would likely be re-rated downward substantially due to the substantial loss that would be incurred arising from the TRF contracts, and the loss of confidence in CITIC's management in taking substantial speculative bets on the currencies.

258. The Tribunal has already made clear that, in its opinion, in coming to her findings stated above, Ms Stella Fung conflated the two distinct concepts of 'price sensitivity' and 'material adverse change in the financial position of a company'. In short, put simply, the conclusions drawn by her were (in the main) drawn on an incorrect premise.

259. What then, in the judgment of the Tribunal, are the defining characteristics of this latter concept?

Interpretative Guidance

260. In seeking to understand the nature and extent of the concept of 'material adverse change in the financial position of a company', the Tribunal has noted that the concept has not been defined in the Listing Rules nor in the Ordinance. Nor was the Tribunal referred to any Hong Kong statute of assistance.

261. Accordingly, the Tribunal has directed itself that the concept, having arisen in a regulatory context in the present case, falls to be ascertained within that context. In this regard, the Tribunal has acknowledged that "the proper starting point in statutory interpretation, as well as constitutional and contractual interpretation, is to look at the relevant words or provisions, having regard to context and purpose."[39] The Tribunal has further acknowledged that words are to be given their natural and ordinary meaning unless the context or purpose points to a different meaning.[40]

262. It is apparent to the Tribunal that the inclusion of the 'no material adverse change' statement in the Dah Chong Hong circular was, pursuant to the requirements of the Listing Rules, directed at shareholders, the purpose being primarily to assure them that there had been no material adverse change in CITIC's financial position by reason of the connected transaction which was the subject of the circular and also to assure them, more generally,

[39] Per Ma CJ in *Leung Chun Ying v Ho Chun Yan Albert* (2013) 16 HKCFAR 735, page 753.

[40] Per Li CJ in *HKSAR v Cheung Kwun Yin* (2009) 12 HKCFAR 568, page 574.

that there had been no such change since the last published audited accounts.[41]

263. Importantly, for the reasons set out later in this chapter, the Tribunal is satisfied that the requirement to inform shareholders of whether, since the last published audited accounts, there had been a material adverse change in CITIC's financial position, was not a requirement simply to advise shareholders of whether the directors had knowledge of price sensitive information or a requirement to give some allied assurance of general financial 'good health', both being advocated on behalf of the SFC. It was a more specific requirement, one related to whether there had been a change in CITIC's financial position of such significance that it had undermined the Group's financial integrity and had done so not merely temporarily but in all the circumstances for an enduring period.

The Defining Characteristics of 'Material Adverse Change'

264. During the course of submissions, the authority most relied upon by the parties was the judgment in the Commercial Court of the Queen's Bench Division of *Grupo Hotelero Urvasco SA v Carey Value Added SL* [42] in which the interpretation of a 'material adverse change' clause in a loan agreement fell for consideration, the essential issue being whether there had, over a specific period of time, being a material adverse change in the

[41] The Dah Chong Hong circular provided details of an essentially inconsequential connected transaction but not all connected transactions are of that mundane nature; many may point to matters that will have a very significant impact on the financial position of a company.

[42] [2013] EWHC 1039 (Comm).

financial condition of the borrower enabling the lender to consider the borrower to be in default[43].

265. *Grupo Hotelero* was decided within the context of contractual obligations arising out of a private commercial agreement. The other judgments to which the Tribunal was referred also related to commercial agreements and not to issues of public regulation. That said, the requirement within the Listing Rules for an announcement to be made as to 'material adverse change' is itself quintessentially commercial in nature, addressing shareholders as to the question of a company's financial integrity, an issue more profound than that of whether at that moment in time a company is in possession of price sensitive information. In the view of the Tribunal, therefore, the requirement within the Listing Rules must be read as a requirement understood in commercial terms.

266. In this regard, the Tribunal has taken note of the of the fact that the Listing Rules themselves, in distinguishing between the obligations imposed pursuant to section 13.09 of the Rules and the independent obligation to make an announcement as to 'material adverse change', must have intentionally drafted the second obligation so as to align it with a well understood commercial concept in private commercial law. Put simply, the first obligation requires the disclosure of information that might reasonably be expected to materially affect market activity concerning the price of a company's shares: this being essentially, therefore, price sensitive

[43] By way of a broad factual overview, it can be said that the claimant, GHU [Grupo Hotelero Urvasco] brought a claim for damages against Carey [Carey Value Added] for failing to advance funding under a loan agreement and thereby frustrating its completion of a building development in London. The matter was defended by Carey on two principal grounds As expressed by Blair J – para 5 of the judgment – the first ground concerned alleged 'financial defaults' arising from the financial difficulties in which it said that GHU had found itself, these difficulties being associated with the collapse of the Spanish property market This part of the case, said Blair J, raised significant issues as to the application of the 'material adverse change' clause that "routinely appears in corporate loan agreements internationally".

information. The second obligation, however, requires a company to announce whether there has been any material adverse change in its financial or trading position since the date to which the last published audited accounts had been made up. The two obligations are expressed in different language. This raises the question: why employ different language in drafting the two obligations unless a distinction is intended? It raises the further question, why employ words widely used in the common law world in private commercial matters to describe a very particular commercial concept unless it is intended that the words should reflect that concept?

267. Turning to the particular component parts of the concept of 'material adverse change in the financial position of the company', it is, first, fundamental to have an appreciation of how the concept of 'materiality' has come to be understood in the common law jurisprudence.

A. Materiality

268. In seeking to define the issue of materiality, in *Grupo Hotelero*, Blair J said (paragraphs 356 and 357):

> "The *Encyclopaedia of Banking Law* says … that "it is considered that normally an adverse change in financial condition would be material if the change would have caused the bank not to lend at all or to lend on significantly more onerous terms, e.g. as to margin, maturity or security". Zakrzewski [an American academic writer on the subject] puts it slightly differently, considering a change to be material that substantially affects the borrower's ability to repay, or, more generally, significantly increases the risks assumed by the lender. In other words, to be material, the adverse change must be

> material in a substantial way to the borrower's ability to perform the transaction in question.
>
> I agree with this approach. Unless the adverse change in its financial condition significantly affects the borrower's ability to perform its obligations, and in particular its ability to repay the loan, it is not a material change."

269. Blair J emphasised the importance of equating the concept of materiality in this context with a change of such significance that it is, for example, a change that would cause a bank not to lend to an existing customer at all or to lend on significantly more onerous terms. Such a change would have to be of such significance that, by way of further example, it would "substantially" affect a borrower's ability to repay a debt due. It must therefore be a change that alters the financial integrity of a company, a change that is deep-seated. In this regard, he said -

> "Unless the clause is read in this way, a lender may be in a position to suspend lending and/or call a default at a time when the borrower's financial condition does not fully justify it, thereby propelling it towards insolvency."

270. In a later judgment of the Commercial Court, that of *Decura IM Investments LLP v UBS AG,*[44] Burton J, relying on Blair J's analysis, held that the court should construe the word 'material' as having the effect of being 'very significant'.

271. As to the issue of 'materiality' in the present case, Mr Richard Harris, on behalf of the SFC, was of the stated opinion that the materiality of

[44] [2015] EWHC 171 (Comm).

unrealised losses under the TRF contracts could be illustrated by way of an analysis of the estimated mark-to-market losses at different periods of time between July and November 2008, these losses being based on fluctuating Australian dollar exchange rates. In this regard, he included a chart – Table 4 - which purported to set out the progression of losses as a percentage of CITIC's 2007 annual profits.

272. Mr Richard Harris was cross-examined at some length on this important issue. Nothing is served by going into blow-by-blow details of the cross-examination. Suffice to say that Mr Richard Harris divorced himself entirely from the Table and its results, accepting that it was wrong "on a philosophical level". As he said to the Tribunal: "The analysis that I did for the purposes of Table 4 … was done on really rough and ready methodology that I believe now to be incorrect."

273. Mr Richard Harris then made reference to new calculations which, with respect to him, were shown to contain a number of errors. In the result, the Tribunal was not able to place any reliance on Mr Harris' evidence concerning this matter of 'materiality'. Nor, it appears, did Mr Bell, in the course of his closing submissions, seek any support from them.

B. Duration

274. For a change to be 'very significant', the authorities indicate that it must be a change that will endure. In this regard, Blair J held that a temporary change only would not be considered sufficient to trigger a material adverse change clause. This, he said, was consistent with the approach which the English courts had taken in regard to material adverse change clauses in company acquisition agreements and also appeared to be

the approach in US case law. In this latter regard, he cited *IBP Inc v Tyson Foods Inc*[45] in which the Delaware Court of Chancery construed a material adverse effect clause –

> "… as best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a *durationally significant* manner". [emphasis added]

275. In the later judgment of *Decura IM Investments* (just cited), the court recorded that –

> "Both parties accepted before me that, if any changes… were simply temporary changes, they would not have been material."

276. The Tribunal accepts that no exact measurement can be given to a matter that is "durationally significant". The measurement is to be found in the circumstances of each and every case. However, by way of general observation, in respect of a company such as CITIC with such a depth of assets, ongoing business enterprises and access to very significant borrowings, the measurement would have to encompass months and not simply days.

C. Evidential Considerations

277. As to the evidential matters to be taken into account in assessing whether a 'material adverse change' in the financial position of a company had taken place, Blair J in *Grupo Hotelero* said that normally an assessment should begin with the financial information available at the relevant times

[45] 789 A2d 14 (Del Ch 2001) 65.

and a lender seeking to demonstrate a material adverse change should do so by reference to that information. However, an assessment was not necessarily limited to the relevant financial information if there was other "compelling" evidence.

278. By way of a summary, Blair J said the following (paragraph 364):

> "The interpretation of a 'material adverse change' clause depends on the terms of the clause construed according to well established principles. In the present case, the clause is in simple form, the borrower representing that there has been no material adverse change in its financial condition since the date of the loan agreement. Under such terms, the assessment of the financial condition of the borrower should normally begin with its financial information at the relevant times, and the lenders seeking to demonstrate a material adverse change should show an adverse change over the period in question by reference to that information. However, the enquiry is not necessarily limited to the financial information if there is other compelling evidence. The adverse change will be material if it significantly affects the borrower's ability to repay the loan in question. However, a lender cannot trigger such a clause on the basis of circumstances of which it was aware at the time of the agreement. Finally, it is up to the lender to prove the breach."

D. The Rigour of the Test

279. In the view of the Tribunal, what emerges is that, for a material adverse change to a company's financial position to be demonstrated to the required standard, the change must be one of deep significance to that company's existing financial position, a change that has undermined its financial integrity. More than that, it must be demonstrated to be a change

that is not merely temporary but is one that, judged in all the circumstances, is a change that will endure, certainly (in the present instance) over a matter of months or longer.

280. In his judgment in *Grupo Hotelero* (paragraph 334), Blair J recognised that there was a relative paucity of authority concerning the concept of 'material adverse change'. He suggested that this perhaps reflected–

> "… the fact that (unlike an insolvency event which is usually clear cut) the interpretation of such provisions may be uncertain, *proof of breach difficult* and the consequences of wrongful invocation by the lender severe, both in terms of reputation and legal liability to the borrower." [emphasis added]

281. Blair J continued by recognising that the Delaware Chancery Court, a leading forum for corporate merger litigation, viewed material adverse change clauses as being *sui generis* and had never found a material adverse change to have occurred. He emphasised, however, that this should not be overstated. It may be demonstrated that circumstances "may be such that it is obvious that the borrower's financial condition has deteriorated to the extent that the repayment of advances is in serious doubt. In such circumstances, the lender may be exonerated from what amounts to throwing good money after bad".

282. Those comments (of themselves) indicate the need for evidence of a change of some profundity, an interpretative approach adopted by the United Kingdom Takeover Panel in *Offer by WWP Group Plc for Tempus Group Plc, Takeover Panel Statement 2001/15* in which it was said that the

Panel supported a very high threshold for establishing a material adverse change in the context of takeover contracts. In its findings, the Panel said that, for a material adverse change provision to be triggered, "an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question" must be demonstrated, this being analogous to something that would justify frustration of a legal contract.

283. Pausing for a moment, the Tribunal records that, in its view, it was regrettable that neither of the expert witnesses called by the SFC, in dealing with the essential issue of whether on 9 September 2008 CITIC's derivatives exposure constituted an actual material adverse change in its financial position, made reference to any of the defining characteristics that have just been considered. The Tribunal must assume that this is because the two expert witnesses, not being lawyers, were not instructed that the concept of 'material adverse change' was a concept independent of, and to be distinguished from, the concept of 'price sensitivity'. In the result, as already indicated, the Tribunal is satisfied that Ms Stella Fung essentially spoke of the information contained in her tranches 'C' through to 'F' as constituting price sensitive information and, to a lesser degree, Mr Richard Harris fell into similar error. In this regard, it is to be mentioned that Mr Bell himself, on behalf of the SFC, appeared to conflate the two concepts when, in the course of his final submissions, he spoke of the test as to whether there had been a material adverse change being assessed by reference to changes that would materially affect investment behaviour.

284. In looking to the breadth of the concept of 'material adverse change', it was central to the submissions of counsel representing the specified persons that forecasts, projections and uncrystallised losses, even if they indicate the likely (or very likely) occurrence of material adverse

change in do not *per se* amount to an actual material adverse change. Put another way, it was submitted by counsel that it was not sufficient, in order to establish the fact of an existing adverse material change, simply to demonstrate that, because of existing circumstances, the most likely outcome was such a change.

285. It was never in dispute that the statement which is the subject of this report spoke in clear terms of an existing state of affairs and not a prospective state of affairs. The statement said that the directors were not aware of any material adverse change in the financial or trading position of the CITIC Group since 31 December 2007. It was a statement that looked to the past and to the current position. Nothing suggests that the words used were intended to encompass a future state of affairs.

E. Contrasting 'Actual' and 'Prospective' Changes

286. The authorities to which the Tribunal was referred during the course of submissions recognise a distinction between 'material adverse change' provisions in commercial contracts which address, first, an *existing* state of affairs (as in the 'no adverse material change' statement that appeared in the Dah Chong Hong circular) and, second, those which encompass a *future* state of affairs by requiring proof only that a set of circumstances have come into existence which will, or will reasonably be expected, to result in the creation of a material adverse change. In this regard, see, for instance, *Canberra Advance Bank Ltd and Another v Benny and Others*[46], a decision of the General Division of the Federal Court of Australia:

[46] (1992) 115 ALR 207, at page 217.

> "… We agree with his Honour's conclusion that none of the five matters that have earlier been identified in these reasons amounted to a change in "the financial condition of an associated person" within the meaning… of the deed of covenant. It is true that Mr Benny's projected figures in late 1989 were materially different from those supplied by Mr Da Deppo to the bank in mid-1990. However, mere projections do not constitute 'change'. They may be evidence of changes that have occurred or they may be evidence of changes that will or might occur but, without more, it would be unsound to rely on two differing projections as evidence in that a change in the financial condition of the relevant companies had in fact occurred."

287. The distinction has been recognised in the recent case of *Decura IM Investments*[47] in which the issue in contention was the wording of a 'material adverse effect' clause in a loan agreement, this being 'Issue 3'. The clause contemplated the cessation of business of the one party where "such cessation … has a material adverse effect on UBS IB's ability to market the Exclusive Business Services.". In respect of the wording of the clause, Burton J said:

> "So far as Issue 3 is concerned, in which I must reach a conclusion as to whether, if there was a relevant cessation, it had (*not* was likely to have), a material adverse effect on UBS's ability to market the EBS, this is of course a decision for me, and (particularly in the absence of any reference such as "in the reasonable opinion of" …) must, as both parties accept, be tested objectively."

288. Later the Judge observed:

[47] See footnote 44.

> "The issue is one of actual (not likely) material impairment of the ability to market…"

289. Current US jurisprudence also appears to emphasise the clear meaning of the words used. In the 1999 case of *Goodman v Raytheon*[48] the wording of a material adverse change clause fell for consideration. The wording was to the following effect; namely, that "there has been no material adverse change in the business condition of the acquired business…" Preska J, in giving judgment, recorded the assertion of the plaintiffs that there can be no reasonable meaning attributed to a material adverse change clause in respect of business or financial condition that does not involve future prospects. He rejected this assertion, saying:

> "As for the Plaintiff's theory that 'future prospects' must be included in the definition of 'financial condition', 'business' or 'assets' the parties failed to include such a meaning in the agreement, and I decline the invitation to insert it by judicial construction."

F. The Issue of Unrealised Losses

290. In the context of this report - the relevant losses being entirely unrealised losses - an issue of fundamental importance may be expressed in the question: are unrealised losses (of themselves) capable of constituting an actual material adverse change as opposed to a prospective change? In this regard, again, the authority of most assistance was that of *Grupo Hotelero*.

291. One of the issues that fell for determination by Blair J concerned the relevance of unrealised exchange losses when determining whether a

[48] Unreported, number 98 Civ 2774 (LAP) (SDNY) Aug 31 1999 WL 681382.

material adverse change in the financial position of a borrower had come into existence. The exchange losses had arisen from the fact that the borrower was liable to repay a creditor in euros but had set its base currency in sterling so that – similar to CITIC – as sterling weakened, the borrower would require more of that currency to repay the same amount of euros.

292. In deciding that certain exchange losses should *not* be taken into account, Blair J said (at para 497):

> "However, as GHU submitted, in my view correctly, these are unrealised and uncrystallised losses. They did not result in a cash outflow, and did not reflect liabilities which had to be settled by GHU or Urvasco Ltd as at 30 June 2008. The actual amount of the liabilities of GHU and Urvasco Ltd would depend on future movements in the exchange rate up to the date when the liabilities fell due for payment."

293. Blair J went on to observe that:

> "In any case, some of the BBVA loan could have been repaid using euro proceeds out of the sums payable under the SPA."

294. That said, Blair J went on to find that, the issue being one of judgment, whether an exposure to loss through derivative instruments was capable (of itself) of constituting an existing material adverse change in the financial position of a company depended on the particular circumstances, there being no hard and fast rule. In this regard, he said (para 536):

> "A material adverse change in a borrower's derivatives exposure, if it can be demonstrated, may, in my view, go to show a material adverse

> change in the borrower's financial condition. GHU ultimately accepted that there is bound to be a degree of judgment involved, and there cannot be a hard and fast rule. So it was accepted that if one has a derivative that is about to mature, the position maybe different than in relation to a derivative which is going to mature sometime in the future. Otherwise, it was said, one has to assume the derivatives are going to continue through to maturity. The question is one of value in respect of a future and contingent right to an asset which is changing in value over time."

295. As to the factors relevant in making a determination of this nature, Blair J said (at para 537):

> "In my opinion, the position depends on the particular facts of the case. An apparently serious exposure to derivatives may, on analysis, be less so, and vice versa, when considered against its effect on the borrower's ability to repay the loan in question, which is the question which is relevant to materiality. The likelihood of margin calls or compulsory closeout prior to maturity, may be relevant."

296. It was, of course, critical to the SFC case that unrealised losses are capable, without more, of constituting an actual material adverse change in the financial position of a company. As Mr Bell expressed it in his final submissions, "exposure" to loss, provided it is of sufficient magnitude in all the circumstances, suffices to prove the existence of a material adverse change.

297. In accordance with the reasoning of Blair J in *Grupo Hotelero*, the Tribunal is prepared to accept that − the identification of a 'material adverse change' being a matter of objective judgement − unrealised losses may be shown to constitute an existing material adverse change. The danger to be

avoided, of course, is to conflate the concepts of *existing* material adverse change and *prospective* material adverse change. In the judgment of the Tribunal, therefore, with reference to the present case, what was to be demonstrated was that the unrealised losses, having regard to their magnitude and the relative imminence of their crystallisation, were so manifestly unavoidable that in the circumstances they constituted an existing material adverse change.

298. In this regard, whatever the apparent magnitude of the mark-to-market losses facing CITIC on 9 September 2008, it is to be understood that as at that date they were entirely unrealised losses and, as such, were dependent on the Australian dollar/US dollar exchange rates (upon which they were based) remaining constant throughout the remaining tenure of the TRF contracts. It is further to be understood that the mark-to-market losses only had to be reported in the Group's profit and loss accounts on the required reporting dates. There was therefore no question of an actual imminent crystallisation of capital loss.

299. There was, for example, no evidence put before the Tribunal of any absolute need, or of a panicked intention, to terminate all the remaining TRF consequences no matter what the loss. It was instead (in the days immediately following the Sunday meeting) a case of actively investigating the feasibility of terminating a number of the TRF contracts at that time as part of the overall remedial measures that were being considered. Clearly, Mr Larry Yung wanted to be rid of these 'accumulators' – inherently speculative instruments – as soon as it made sense to do so. But that is different from an expressed economic compulsion to sell. There was, for example, no evidence that the cash flow stress of having to purchase the highly leveraged Australian dollar deliverables left no option other than to

terminate the contracts. Indeed, after investigation, a credible cash flow analysis found that it was within the means of the Group to meet the cash flow requirements that were imminent and, assuming a constant exchange rate, that would accrue over the next 18 months. By way of summary, therefore, there was no evidence, objectively judged, that, on or about 9 September 2008, the only option facing CITIC was to terminate the Australian dollar TRF contracts and thereby to crystallise the mark-to-market losses.[49]

300. Ms Stella Fung accepted that mark-to-market losses, necessarily being unrealised losses, were subject to change, indeed material change, with the daily fluctuations in the relevant exchange rates and changes in important value calculations such as calculations concerning historic and implied volatility. She accepted that the mark-to-market values may reflect but do not determine the deliverable amounts under those contracts. She further accepted that if a TRF contract runs to maturity, the mark-to-market value of that contract will be zero.

301. Mr Richard Harris accepted that in the present case the mark-to-market losses on the TRF contracts would have been highly sensitive to changes in the spot rate and that a small movement in the spot rate could lead to a material change in the mark-to-market value. Mr Richard Harris accepted that on 4 September 2008 CITIC's senior management would not have known what the spot rate would be, for example, on 12 September 2008 and that, in that short span of time, the mark-to-market values could go up or down in a drastic fashion. The following exchange between leading counsel

[49] The Tribunal accepts of course that, while not the only option, termination of certain of the TRF contracts when the market best allowed was one of the options open to CITIC in order to avoid carrying too high a level of foreign currency risk, more especially as the speculative nature of the TRF contracts, was against CITIC's established policy. As stated elsewhere in this report, termination was at all times *one* of the options considered.

for Mr Henry Fan, Mr Jat Sew Tong SC, and Mr Richard Harris illustrates the point:

> "Q: Of course, CITIC management would not know on 4 September what the spot rate would be on 12 September?
>
> A: Correct.
>
> Q: So it could go up, it could go down rather drastically –
>
> A: Correct.
>
> Q: It could change the total amount very quickly.
>
> A: Yes."

302. Ms Stella Fung also accepted that changes in mark-to-market values by themselves may not necessarily have posed an immediate concern to CITIC if it had been able to deploy the necessary funds to pay for the magnified Australian dollar 'deliverables' due under the contracts.

303. Of relevance, in the view of the Tribunal, is the fact that both Ms Stella Fung and Mr Richard Harris accepted that, because of the unprecedented volatility in the Australian dollar exchange rate at or about the material time, this would have had the effect of increasing (perhaps substantially increasing) the mark-to-market losses attributed to each of the TRF contracts. Mr Richard Harris explained that mark-to-market values are derived from complex mathematical calculations. There is no universally accepted algorithm and different valuing models may be jealously guarded by the issuing banks. One input into a valuation, he said, concerned implied volatility. This is not, however, an objectively verifiable fact and is non-directional. However, an increased implied volatility would certainly have weighed negatively on the mark-to-market values that were given to the CITIC TRF contracts at the time. Again, put simply, if the exchange market in respect of Australian dollars had, in the days ahead, regained some

stability, that itself would have worked towards reducing mark-to-market losses.

304. The greater danger, it was suggested on behalf of the specified persons, lay not in hypothetical values changing from day to day but rather in CITIC's ability to manage the magnified cash flow requirements to pay to the increasing value of Australian dollars to be acquired under each TRF contract. In this regard, it was said, there was no cash flow analysis placed before those who attended the Sunday meeting to demonstrate that, at or about that time, CITIC did not have the ability to manage any cash flow demands.

305. In any event, so it was submitted, the fact that CITIC was obliged under the TRF contracts to take delivery of Australian dollars did not of itself amount to an incurred loss. Any loss that may be incurred, depending on fluctuations in the exchange rates, would be spread over many months and would depend on a number of factors; for example, whether CITIC chose to keep Australian dollars to pay not only for the capital costs of the Sino Iron Project but also for the operating costs and whether CITIC chose to sell Australian dollars back into the market.

306. In this regard, the Tribunal heard evidence that at or about the material time the 'capex' estimated for the Sino Iron Project stood at AU$1.6 billion up to 2010 while the 'opex' was calculated to be about AU$1 billion a year over a 25 year period. When questioned on this matter, Ms Stella Fung accepted that if the Australian dollar 'deliverables' could be deployed and used in the Sino Iron Project there would be no issue of over-hedging. The Tribunal accepts, of course, that at the material time CITIC had no intention to hedge its requirement for Australian dollars over such a long

period of time. The issue, however, is not so much one of 'intention' but whether, in order to avoid a material adverse change in its financial position, there were viable options at or about the material time open to CITIC.

307. The Tribunal considers it of importance, not simply that the specified persons at the Sunday meeting had no analysis of cash flow to assist them in assessing the Group's ability to manage the prospective cash flow stress, but equally that the subsequent cash flow analysis presented to the task force on 15 September 2008 revealed that, as matters stood, the Group would be able to manage the cash flow problem for an extended period of time, certainly to the end of 2009.[50]

308. By way of summary, what can be said is that there was no evidence of any real substance placed before the Tribunal to indicate that, as at the material time or indeed over the ensuing few weeks, CITIC was unable to meet its obligations under the outstanding TRF contracts. Its asset level and its cash flow position were sufficient to afford the deliverables due under the TRF contracts at that time and over a reasonably extended period of time into the future. As at the material time, it appeared that the cash flow demands on CITIC would have been about HK$150 million per month (on the basis of a loss of aroundHK$3.6 billion). CITIC at the time had in place cash and bank facilities of around HK$20 billion.

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[50] Concerning the cash flow analysis prepared for the task force meeting, Mr Steve Kwok said that, as professional managers, in preparing the analysis, he and his team considered it appropriate to review the Group's assets and to consider whether any could be sold if necessary. He confirmed that a review of this kind was not abnormal for CITIC, it being an investment holding company. He accepted that he had separated assets into those that could be sold more quickly and those that would probably take longer to sell. He accepted that the turbulence of the market at that time did not present a good opportunity for disposing of assets. But he emphasised that this part of the cash flow analysis had been presented in case there was a future need for assets and not because the analysis revealed that there was any existing such need.

309. It was the testimony of Ms Stella Fung, who appears not to have conducted any detailed cash flow analysis, that the cash flow pressures would have had a material impact on the share price once relevant details were released to the market. In short, that the information was price sensitive. For the reasons now to be outlined, however, the Tribunal is satisfied that this was a misconceived basis for assessing 'material adverse change'.

Distinguishing 'Price Sensitivity' and 'Material Adverse Change'

310. It was fundamental to the defence raised by the specified persons that the two concepts of 'price sensitivity' and 'material adverse change' in the financial position of a company are different and distinct concepts. The mere fact that information may be price sensitive does not prove that it represents a material adverse change to the financial position of a company. Information may be both material to a company's financial position and also price sensitive. However, the fact that information is price sensitive does not necessarily mean it is material to a company's financial position.

311. On a consideration of the submissions, the Tribunal had no difficulty in coming to the determination that the two concepts are different and distinct. It may be said, by way of broad definition, that information is price sensitive if it is information which would influence the ordinary reasonable investor to buy or sell shares. As it was said during the course of submissions, the concept therefore depends on the perceptions of the investing public. By contrast, the concept of 'material adverse change' in the financial position of a company is not to be determined by having regard to the perceptions of the market, it is to be determined objectively; that is, by looking primarily to the available financial information, and to other relevant

information of importance, in order to reach a judgment as to whether in fact such a state of affairs has come about. In the present case, that objective judgment fell to be made by the Tribunal.

312. During submissions, it was suggested that, while the concept of 'price sensitivity' is to be viewed through the eyes of the ordinary reasonable investor, the concept of 'material adverse change' in the financial position of a company is to be viewed through the eyes of a corporate treasurer. While not formally adopting that as a test, the Tribunal recognises that it is an effective way of emphasising the difference in the concepts.

313. As earlier stated, the Tribunal is satisfied that Ms Stella Fung (in particular) allowed herself to elevate the concept of price sensitivity, that is, information that may have influenced the ordinary reasonable investor to dispose of CITIC shares, so that it was conflated with the more rigorous concept of material adverse change at the material time in CITIC's financial position; indeed, an existing material adverse change as opposed to a prospective one.

314. In her expert report dated 7 November 2014, Ms Stella Fung spoke consistently of the likely effect on CITIC's share price of financial information which she had identified; namely, on the reaction of the market. By way of example –

(i) In respect of 'Information B' (financial information available to CITIC on 4 September 2008 for its ExCo meeting) she said:

> “Therefore, I am of the view that it might be premature to conclude that Information B would likely effect on CITIC’s share price when it was made known to the public.”

(ii) In respect of Information F (financial information available at the Sunday meeting) she said:

> “I am of the view that if Information F was made known to the investing public, the share price of CITIC would likely be re-rated downward substantially due to the substantial loss that would be incurred arising from the TRF contracts and the loss of confidence in CITIC’s management in taking substantial speculative bets on the currencies.”

315. While in cross-examination Ms Stella Fung appeared to accept that there was a distinction between the concepts of ‘price sensitivity’ and ‘material adverse change’, she held to the view that, whether there had been a material adverse change in the financial position of a company or not, was to be determined from the investor’s perspective and not as a matter of judgment based upon an objective consideration of all available financial evidence and other relevant evidence of importance. By way of illustration, she confirmed in the course of cross-examination that, when signing a no material adverse change statement, a director of a listed company should put himself in the shoes of an investor, deciding the issue from the perspective of the investor.

316. Mr Richard Harris himself, although he too accepted the distinction in the concepts of ‘price sensitivity’ and ‘material adverse change’, appeared also in his expert report of 26 February 2015 to come close to conflating the two. He spoke, for example, of the fact that losses

would be considered to be ‘material’ to the financial position of CITIC “where they would have the potential to detrimentally affect the confidence of the Company’s stakeholders, which include managers, bankers, staff and shareholders”. Later in his report, he said that the shock to the market of receiving information concerning the TRF contracts – at a time when investors were highly sensitive to losses from hitherto unexplained sources – would have made the losses more material to investors earlier in the loss cycle.

317. In summary, the Tribunal is satisfied that the two expert witnesses (and the SFC itself in so far as it adopted their evidence in this respect) were wrong in the circumstances of this case to use ‘price sensitivity’ as the overriding barometer in seeking to measure whether in fact on 9 September 2008 there had been a material adverse change in the financial position of the CITIC Group.

The SFC Case

318. In making his final submissions on behalf of the SFC, Mr Bell focused essentially on the 16 Australian dollar/US dollar TRF contracts that remained outstanding in early September 2008; 12 of the 16 contracts being entered into within the space of about one month between 8 July and 5 August 2008. A list of these 16 contracts together with a description of their essential features is annexed to this report as Annexure E. As Mr Bell observed, although CITIC also had outstanding TRF contracts denominated in other currencies, these 16 contracts created by far the greatest exposure. Of the 16 contracts, the last 12, by reason of their particular features, carried the greatest risk: these features including the incorporation of increased leveraged ratios and aggressive step-up strike rates.

319. It was Mr Bell's submission that, as at 9 September 2008, these 16 TRF contracts alone constituted a material adverse change in CITIC's financial position. Their mark-to-market values and the requirement pursuant to each contract to purchase increased amounts of Australian dollars (the 'deliverables') calculated at different spot rates were measurements of that exposure. As he put it:

> "… no matter how the specified persons may seek to diminish the value or usefulness of these measurements, they cannot deny the fact that the 16 Australian dollar TRF contracts were extremely damaging to CITIC's financial position as at 9 September 2008. This remains the case regardless of how one may wish to quantify or value the 16 Australian dollar TRF contracts. No amount of technical analysis can change the fact that CITIC was in early September 2008 holding onto a *completely unwanted, unintended and massive naked position* in the Australian dollar in the midst of a global financial crisis and worldwide liquidity crunch."[51]

320. Mr Bell went on to describe this 'naked' position as being "speculative in nature and contrary to published company policy against speculative trading"[52]. The 16 Australian dollar TRF contracts, he said, presented an uncontrollable and potentially bottomless exposure.

321. As earlier stated, two bases were used for assessing the financial impact of CITIC's exposure to loss (as opposed to actual loss) under the TRF contracts. The first was to take into account the mark-to-market value of

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[51] It was never disputed by the specified persons that the exposure under the TRF contracts was 'unwanted' and 'unintended'.

[52] Nor was it disputed that, when considered after the event, the TRF contracts were clearly speculative instruments, a matter that caused Mr Larry Yung particular distress.

each of the contracts, that is, to take into account an estimated price (calculated by the issuer of each contract) at which, at a particular moment in time, each contract hypothetically could be traded in the market. The second was to assess the financial stress, that is, the cash flow stress, imposed by having to purchase magnified amounts of currency over an extended period of time.

322. In respect of mark-to-market losses, it was Mr Bell's submissions that those who attended the Sunday meeting had data presented to them that showed that, in accordance with set spot rates, CITIC was staring at mark-to-market losses in the region of "several billion" dollars. As he put it:

> "A loss of this size arising from a mere 16 structured foreign exchange contracts could wipe out the net profits of the entire CITIC Group from *all* its operations for the first six months of 2008 [around HK$5 billion]."

323. Mr Bell said that, viewed from the perspective of the investing public, the 'no material adverse change' statement appearing in the Dah Chong Hong circular was a positive statement as to the financial health of the CITIC Group at that point in time. As such, he argued, even though the mark-to-market losses were in the nature of unrealised losses, they were nevertheless directly relevant to the determination of the financial health of the CITIC Group at that point in time.

324. In respect of cash flow stress, Mr Bell said –

> "As the prevailing Australian dollar spot rates in early September 2008, the expected Australian dollar deliverables were around AU$6.7 billion (approximately HK$40 billion) to AUD$7.7 billion

> (approximately HK$50 billion)[53]. The maximum Australian dollar deliverable was AUD$9.4 billion (approximately HK$60 billion)."[54]

325. Mr Bell accepted that the Australian dollar 'deliverables' would be spread over 24 months. He also accepted that CITIC could sell each batch of Australian dollar 'deliverables' as they came in in order, in part, to finance the next batch of deliverables. But it was his submission that these factors could not–

> " … diminish the objective fact that the expected Australian dollar deliverable amounts were at a staggering 4 to 5 times higher than CITIC' cash and bank deposits as at 30 June 2008 (of HK$10.7 billion)."

326. Mr Bell went on to observe:

> "Honouring the 16 AUD TRF contracts would be a material financial drain on CITIC's cash flow even if CITIC may ultimately be able to pay for the Australian dollars one way or another. This is especially in the context of the specific circumstances that CITIC was facing at the time: (i) a lot of ongoing projects requiring cash; and (ii) tightening credit facilities from banks due to a worldwide liquidity crunch."

327. Without detracting from the strength of his final submissions, as the Tribunal has understood it, Mr Bell's case was based on the forthright premise that the financial figures presented to the specified persons who attended the Sunday meeting, when taken together with other figures that

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[53] Per the report of Ms Stella Fung, paragraph 50 (using the Australian dollar spot rate on 4 September 2008.

[54] This was using the Australian dollar spot rate at 4 September 2008 of around 0.83.

would have been available to them over the next couple of days, would have required no in-depth analysis to understand their import. As he put it, no amount of technical analysis could change the fact that CITIC was holding onto a "massive naked position", one that at that moment in time would manifestly have presented itself as constituting an existing and highly significant undermining of CITIC's financial integrity.

328. As to the fact that, as at 9 September 2008, no actual losses had been incurred; in short, that the losses were prospective, it was Mr Bell's submission that, despite the depth of CITIC's wealth (allied to an ability to obtain funding) and its ability to generate profits by way of its general business operations, it found itself facing what may be described as a financial tsunami: an overwhelmingly destructive financial onslaught arising out of the reckless use of asymmetrical derivative instruments. The wave may not yet have hit. But CITIC's exposure, that is, the sheer size of the inevitable financial losses, was such that, in the circumstances, it constituted in fact a material adverse change as that term has been defined by the Tribunal. In summary, as the Tribunal has understood it, Mr Bell placed reliance on the dictum of Blair J in *Grupo Hotelero* that –

> "A material adverse change in a borrower's derivatives *exposure*, if it can be demonstrated, may, in my view, go to show a material adverse change in the borrower's financial condition." [Emphasis added]

329. As Blair J said, however, there can be no hard and fast rule; it is always a matter of judgment. The Tribunal accepts, of course, that there may be cases in which the dimensions of an exposure to loss may be of such a magnitude and of such imminence that there can be no misinterpretation of the true predicament. On a consideration of all relevant evidence, however,

the Tribunal does not consider that to be the position in the present case. As Blair J said, an apparently serious exposure to derivatives may, on analysis, be less so, and vice versa. In the present case, clearly, all the specified persons, when they attended the Sunday meeting, were made aware of a threat to CITIC's financial position of major proportions. None of the specified persons sought to downplay the seriousness of the situation that they faced: hence the need for the immediate setting up of a task force which would work confidentially to ascertain, first, the true position and, second, what remedial measures could be taken. But what must be remembered is that CITIC itself had enviable resources. As Mr Peter Lee put it during the course of his evidence, CITIC was so strong that he could not imagine a hedging overexposure imposing a material adverse change in the financial position of the company.

330. What must also be remembered is that the losses facing those who attended the Sunday meeting were unrealised losses: they were prospective losses. Nor was there any question of imminent crystallisation.

331. One of possible remedial measures discussed at the Sunday meeting focused on the termination of certain of the TRF contracts. But there was no ready market for doing so. For all practical purposes, relevant values would have to be assessed by the issuing banks, a relatively opaque and esoteric process. Would it be possible (relatively advantageously) to terminate a limited number of the contracts, taking some of the sting out of the prospective losses? It was a matter which those who attended the Sunday meeting, acting as a body of senior executives, clearly had to investigate before they could know their true position and make an informed decision. What would have been understood, of course, was that any favourable move in the Australian dollar exchange rate would have a direct impact on the

mark-to-market value of the TRF contracts as would a stabilisation in the market: both being legitimate possibilities.

332. What would have been understood is that, assuming a constant exchange rates, as matters stood, the TRF contracts were due to run through to completion and in that intervening period, there could be very material movements in the relevant exchange rates.

333. On this basis, it was the evidence of certain of the specified persons that the real issue, as they saw it, was not so much varying mark-to-market values, they being essentially part of an accountancy construct related to hypothetical values, but was instead the longer term issue of cash flow, that is, of having the ability to pay for the greatly increased amounts of Australian dollars falling due each month under the 16 TRF contracts. On the evidence, it appears, however, that very little data was put before those who attended the Sunday meeting as to how best, if the exchange rate did not improve, CITIC would be able to manage any cash flow stress. This was one of the important matters that fell to be investigated. The matter will be considered a little later in this chapter but it is apparent that at a meeting held on 15 September 2008 the cash flow stress did not appear to be an immediate problem; the cash flow could be managed through the balance of 2008 and through 2009.

334. Expressed succinctly, it was therefore the position of the specified persons that, while the data available to them between 7 and 9 September 2008 was no doubt sufficient to demonstrate the very real danger of a material change in circumstances in CITIC's financial position at some point in the future, that data – within *that* window of time - was not capable of

demonstrating that there was already in existence an actual material adverse change.

335. Yes, there was a crisis to be dealt with; remedial measures to be taken, but, bearing in mind that all losses were prospective, that none were imminently to be crystallised and, in respect of cash flow, bearing in mind the very real strength of CITIC to meet any cash flow stress, that this did not appear to present an insurmountable problem, there was simply insufficient objective evidence of an actual material adverse change in CITIC's financial position.

336. As the Tribunal has understood it, it was Mr Bell's submission that the uncertainties of the future - for example, the fact that in a fluctuating currency market, the Australian dollar may regain some of its strength over the ensuing weeks, thereby materially altering mark-to-market values, was not to the point. Borrowing an analogy used by one of the witnesses, Mr Bell said that what was to the point was that as at 9 September 2008 the 16 TRF contracts amounted to a form of "cancerous tumour". Two days earlier, at the Sunday meeting, all of the specified persons would have been aware of the fact that the exposure under the contracts amounted in financial terms to such a tumour; they would have been aware of its approximate size and nature and yet, he said, they gave a 'clean bill of health' to the investing public.

337. As at 9 September 2008, said Mr Bell, there had come into existence a material adverse change in CITIC's financial position because at that time the exposure under the 16 Australian dollar TRF contracts was –

(i) 'material' to the financial position of CITIC;

(ii) represented a 'change' from the financial position of CITIC as at 31 December 2007, and

(iii) had constituted a change that was undoubtedly 'adverse'.

338. As the Tribunal understood it, it was therefore Mr Bell's submission that, as at 9 September 2008, as contemplated by the Listing Rules, there had been a material adverse change in CITIC's financial position.

339. The Tribunal has had a number of difficulties with this approach, the most fundamental being that, for the reasons set out earlier in this report, it is satisfied that the concept of 'material adverse change', as that concept is contained within the Listing Rules, has taken on a number of defining characteristics. As such, it is not sufficient simply to isolate each word and give it its ordinary everyday meaning without looking to the concept itself and how its nature and extent have been sculptured by relevant jurisprudence.

340. In the view of the Tribunal, Mr Bell also came close to conflating the two distinct concepts of 'price sensitivity' and 'material adverse change'. It was his submission that the regulatory purpose of including a 'material adverse change' statement in the Dah Chong Hong circular was to provide an up-to-date reassurance to the investing public [not just to shareholders] as to the financial health of the company. Mr Bell amplified this by saying that, whether there had been a material adverse change in the financial decision of CITIC or not, should be assessed by reference to those changes in CITIC's financial position that would materially affect investment behaviour.

341. The Tribunal is satisfied, however, that the concept of 'material adverse change' does not constitute simply giving the investing public a clean bill of health. As a concept it is far more specific. It speaks to a very particular set of circumstances, namely, not whether a company has a robust balance sheet, but whether there has been a material adverse change in its financial circumstances of such deep significance that it has undermined the financial integrity of the company in a manner that will endure. That is a far more ominous matter than one of price sensitivity and, in the view of the Tribunal, it is wrong to conflate the two.

342. In the view of the Tribunal the following questions fell to be answered in the affirmative if it was to be demonstrated that, as at 9 September 2008, judged objectively - not through the eyes of the investing public but (as a guide) through the eyes rather of a corporate treasurer - CITIC had experienced a 'material adverse change in its financial position' –

(i) First, can it be said, on any objective analysis, that, on the data available to the specified persons at the material time, the prospective mark-to-market TRF contract losses considered together with the prospective cash flow stresses were evidence of a deeply significant change that had already altered the financial integrity of the CITIC Group?

(ii) Second, can it be said, on any objective analysis, that, on the data available to the specified persons at the material time, such a change was not only deeply significant but was a change that was not merely temporary but would endure?

343. In answering both of these questions, the Tribunal has taken into account all relevant evidence, a good deal of that evidence having already been the subject of comment.

344. As to the first question, while it has not been the easiest matter to resolve, in the judgment of the Tribunal, while there was certainly sufficient data before the specified persons by 9 September 2008 that they were facing a major threat to the financial integrity of the CITIC Group, a threat that, unless the Australian dollar began to recover some of its value, could result in an actual material adverse change in the financial position of the Group, it was not demonstrated that such a change had already occurred.

345. The second question is easier to determine. In the judgment of the Tribunal, having regard to all relevant circumstances, especially the fact that exchange markets were in a state of flux, nothing was put before it demonstrate that, even if a material adverse change had already occurred, it was one that was not purely temporary but clearly would endure.

346. With the benefit of hindsight, of course, looking to what in fact occurred over the ensuing few months, two things can now be said; first, that the threat of a material adverse change, a change that undermined the financial integrity of the Group, did materialise and, second, it can now be said that the change endured. However, as the Tribunal has emphasised much earlier in this report, matters have fallen to be judged within their relevant temporal frameworks.

One Final Issue: Did the Failure to Qualify the 'No Material Adverse Change Statement' Constitute the Omission of a Material Fact?

347. Although it does not appear in any way to have been integral to the SFC argument, and was never argued in stated terms, the Tribunal has recognised that the following proposition may be made; namely: while the 'no adverse material change' statement may not have been false or misleading as to a material fact, nevertheless the failure to qualify that statement by publishing the fact that the directors were, however, aware of important price sensitive information, that is, the prospective losses arising out of the TRF contracts, rendered the statement (on any ordinary reading) false or misleading by the *omission* of a material fact.

348. The proposition essentially is based on the assertion that the purpose of Chapter 14A of the Listing Rules is to keep shareholders and/or the market informed of matters materially affecting the financial and trading interests of listed companies and surely, in appropriate circumstances, in order to meet the spirit as well as the letter of those Rules, the statements to be published should be suitably qualified.

349. To cite it again, the 'no material adverse change' statement was published in accordance with the following requirement:

> "A statement by the directors of any material adverse change in the financial or trading position of the group since the date to which the latest published audited accounts of the issuer have been made up or an appropriate negative statement."

350. In the present context, the question to be determined is therefore whether the word ‘appropriate’, in so far as it qualifies the publication of a negative statement, is to be read as requiring appropriate qualifications to a negative statement; such a qualification, for example, including a requirement to publish information concerning matters that may lead, or are even likely to lead, to a material adverse change.

351. The Tribunal is satisfied, however, that the requirement in terms of which the ‘no material adverse change’ statement was published, does not bear this broad reading –

(i) the requirement places on a listed company the responsibility to announce the fact of an *existing* material adverse change. For good reason, it does not place on a listed company the uncertain responsibility to announce the likelihood (that is, the possibility or probability) of a material adverse change; and

(ii) the requirement to announce matters that may bear on the likelihood (that is, the possibility or probability) of a material change in the financial or trading position of a listed company is imposed under another provision of the Listing Rules: section 13.09(1). Under that provision, a company is required to keep the market informed – “as soon as reasonably practicable” - of any information which is necessary to enable the market to appraise the position of the company and/or that might be reasonably expected to materially affect market activity in dealing in its securities.

> Those broad requirements, it appears, will encompass, if it is appropriate, both present and future circumstances.

352. On this basis, the Tribunal accepts that circumstances may arise in which the obligation falls on a listed company to make two complementary announcements, each pursuant to the separate and independent provisions of the Listing Rules outlined above. In the context of this enquiry, such announcements would be, first, an announcement to the effect that the directors are not aware of any existing material adverse change in the financial position of CITIC and, second, that the directors are, however, aware of price sensitive information – the currency exposure under the TRF contracts – that is reasonably expected to affect market activity in the securities of CITIC.

353. The Tribunal is satisfied that the two obligations are not to be read as being fused into each other.

354. The Tribunal has also recognised the fact that it was never the case of the SFC that the specified persons were (in part) culpable of market misconduct because of a failure at or about the time of publication of the Dah Chong Hong circular to publish an appropriate statement pursuant to section 13.09(1) that it was in possession of information (the currency exposure under the TRF contracts) that would enable the market to better appraise the financial position of the Group and/or would be reasonably expected materially to affect market activity in respect of the Group's securities.

The Requirement to Prove That the Specified Persons Were Not Aware of Any Existing Material Adverse Change

355. As Mr Bell accepted in the presentation of the SFC case, even if it was demonstrated as an objective fact that, as at 9 September 2008 a material adverse change in CITIC's financial position had come into existence, it still fell to be demonstrated that the directors – effectively those who attended the Sunday meeting – had knowledge of that fact.

356. It was the case of the specified persons that they had no such knowledge. Yes, they were aware of a threatened crisis. But at the Sunday meeting and over the days that followed – when the task force was setting about its work – they did not know and had no reasoned basis[55] for believing that any such change had occurred.

357. As stated earlier in this report, there was a persuasive body of evidence placed before the Tribunal (including psychiatric evidence) that by 7 September 2008, when the urgent Sunday meeting took place, Mr Leslie Chang, CITIC's Chief Financial Officer and the Director with the most intimate knowledge of the complexities related to CITIC's currency exposure crisis, was in the early throes of a major depressive disorder. In the result, although clearly he did his best to explain matters to the meeting, indeed assuming responsibility for the crisis and seeking to throw himself on his sword, those who attended the meeting were of the view that much of what was said by him was confused and occasionally contradictory. Indeed, Mr Albert Tam, one of CITIC's forex specialists who was called to the meeting, recalled the meeting being chaotic and confused.

[55] A 'reasoned' basis is one that is founded on the employment of logic and reasoned deduction; in short, one that is rational.

358. In the light of this, as the Tribunal understood it, it was the case of the specified persons who were called to the Sunday meeting to be briefed by Mr Leslie Chang that, although what Mr Leslie Chang told them was cause for deep concern and, if the figures were proved to be correct, was evidence of a threatened crisis of major proportions, they were not able that day (or indeed over the next few days) to reasonably and rationally conclude as experienced business executives that a material adverse change to CITIC's financial position had occurred; a change, that is, that was deeply significant to the financial integrity of the Group and that was "durationally significant".

359. It was the case of the specified persons that, having regard to the confused and sometimes contradictory nature of the material before them, both oral and written, they were in no position to come to any such conclusion, not until they had been able accurately to analyse the exact nature and extent of the exposure under the TRF contracts and, of particular importance, to take account of all available remedial measures. That was why the decision was made at the Sunday meeting to set up a task force; that was the obvious and sensible course to take, an entirely rational course in the circumstances. What was required first was to fully understand the nature of the threat posed by the currency exposure and then to seek to understand whether remedial measures (for example, as to managing cash flow) would be able adequately to contain the threat.

360. In short, it may be said that while - between 7 and 12 September 2008 - the specified persons were aware of circumstances that, unless immediately investigated and combated, may give rise to a material adverse change in the financial position of the CITIC Group, they did not conclude,

simply because they were in no position to do so, that a material adverse change in the financial position of the Group was already in existence.

361. In the judgment of the Tribunal it is important to recognise that at the Sunday meeting and in the days that followed the specified persons found themselves in a position of very considerable uncertainty. The two bases of loss that were presented to them – the mark-to-market valuations attributed to each of the 16 Australian dollar TRF contracts and the spectre of cash flow stress - were both premised on fluctuating exchange rates at a time of very high volatility in the exchange market; at a time when, as the Tribunal has understood it, because of general global turbulence, it would have been difficult in the extreme to anticipate accurately the future movement of the Australian dollar against the US dollar.

362. In the course of cross-examination, Ms Stella Fung accepted that the data made available to those who attended the Sunday meeting (the information classified by her as 'Information F') was a projection of future losses that would be realised only if certain set and constant assumptions held good; more particularly if the spot rates set out in the data remained constant not just over the forthcoming days but over the forthcoming months.

363. Of necessity, therefore, there was a degree of artificiality built into the data presented to those who attended the Sunday meeting. Mr Leslie Chang, when he attempted to explain matters to those at the meeting, spoke of projected losses that would increase or decrease depending on future fluctuations in the currency market.

364. With the benefit of hindsight, it is now known that after 9 September 2008, with the exception of a short pause, the Australian dollar

continued its precipitous fall in value against the US dollar. But there was no evidence put before the Tribunal to the effect that this continued fall was at the relevant time a 'given'. If the Australian dollar had settled, if it had started to regain some of its value in the following days or weeks, that would have had a very material effect on the mark-to-market value of the individual TRF contracts and any cash flow stress arising out of those contracts.

365. In the view of the Tribunal, recognising that mark-to-market values were only ever crystallised when the underlying assets were realised, such values essentially being accounting constructs "based on a hypothetical disposal to a hypothetical buyer in circumstances where no such disposal is proposed or may even take place"[56], those who attended the Sunday meeting must have had (to a greater or lesser degree) a concern not so much as to the fact of the existing mark-to-market losses but what those losses represented in terms of future cash flow stress; namely, the fact that they represented an extended and highly leveraged obligation to purchase Australian dollars at prices well below market prices: that is, if the spot rates remained constant. Yet there was no evidence that any of those who attended the Sunday meeting had before them any detailed analysis or projection of the anticipated cash flow position of CITIC.

366. In such circumstances, it was imperative for the task force, among the other matters under investigation, to come to a determination as to the ability of CITIC to deal with the anticipated cash flow stress. Earlier in this report[57], the Tribunal has made reference to the work carried out by CITIC's Business Development Department (under the management of Mr Steve

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[56] This description is taken from Blair J's judgment in *Grupo Hotelero*, para 534, when describing the similar 'fair value' standard employed in international accountancy standards.

[57] See the section '*cash flow analysis*': paras 164 to 171.

Kwok) to test whether it was within CITIC's ability to manage the over-hedging, that is, to ascertain whether the CITIC Group had sufficient liquidity to manage any cash flow loss arising from the obligations under the TRF contracts, doing so over the balance of those contracts: a period of 20 months or more. As Mr Steve Kwok remembered it, when the analysis was presented to the task force at its meeting on 15 September 2008, nobody at the meeting was of the view that it represented a very significant loss in profits. This was very much the case, he observed, when at the time the task force was looking to a number of measures to alleviate the drain on resources. Yes, there was a cash flow problem but it was not an immediate problem; the cash flow could be managed through 2009 and in that time the opportunity presented itself for rationality to return to the currency markets.

367. In the opinion of the Tribunal, this evidence is of importance. The Tribunal is not seeking here to do what it has already said on a number of occasions must be avoided, that is, to determine matters through the prism of hindsight. It is of importance because, focusing on the Sunday meeting and the days immediately thereafter, it tends to support the view that without any contemporary analysis of the anticipated cash flow position, other than looking at the figures and recognising that they presented a very sombre picture, those at the meeting were simply not in a position to come to any rational decision - that is, as experienced business persons, one based on logic and reason as opposed to emotion; for example, panic - that the over-hedging demands had already very significantly impacted on the financial position of the CITIC Group so as to undermine its financial integrity in a way that was "durationally significant". The results of the later cash flow analysis tend to support the finding that those at the Sunday meeting had rational grounds for holding that, before any determination as to financial

impact could be made, first the true nature of the crisis facing the CITIC Group had to be fully understood.

368. In the opinion of the Tribunal, there were two pressing reasons why it would have been necessary to set up a task force, neither constituting some form of tacit acceptance that CITIC had already found itself in the throes of a material adverse change in its financial position. First, Mr Leslie Chang, while he had raised the alarm, had been in no position to fully explain the nature and extent of his reasons for doing so. Certainly, there were those in the Finance Department who had compiled the necessary analyses and who would have been able to render some assistance. But the fact remains that, with Mr Leslie Chang *hors de combat*, the other directors had lost the assistance of the person who should have been able to guide them as to overriding tactical issues. Second, with the exception of Mr Leslie Chang, everybody else at the Sunday meeting was, to a greater or lesser extent, unfamiliar with the complexities of the derivative instruments that had created the foreign currency exposure.

369. As the Tribunal sees it, in light of the circumstances, sympathy must be given to the position of the specified persons that until, as a body of senior executives, they were capable of understanding the true nature of the threat that was being faced, they could not know how to deal with it and nor, bearing in mind the extraordinary circumstances of the Sunday meeting, could they know at the time whether the CITIC Group not merely faced the threat (or likelihood) of a really significant and enduring change in its financial position but that such a position was in truth an existing fact.

370. In the view of the Tribunal, it is not possible simply to dismiss the assertion made by the specified persons that they required time to consider

the true nature of the threat that faced CITIC. As highly experienced business executives, their judgment calls made at the time are entitled to a margin of appreciation.

371. In this regard, the Tribunal records that, while certain witnesses, trying to remember back over so many years, may unconsciously have sought to some limited degree to colour the evidence to better favour their position, it was impressed by the integrity of all the specified persons and those who gave evidence on their behalf. It is satisfied that the evidence that was given was given in good faith without any conscious attempt at distortion.

372. What cannot be ignored, and has always been a fundamental issue, is that the foreign currency accumulators that had brought about the crisis were complex structured products which since 2008 have prompted regulators to introduce risk disclosure measures. The methodology for assessing their mark-to-market values was at the time opaque. Time was required to fully understand their dynamics.

373. What is to be remembered also is that, in addition to the Australian dollar TRF contracts, there were dual currency contracts - accumulators also - that had to be understood.

374. In business matters, as in military matters, those who must marshal the field must first understand their true position.

375. It was, in the view of the Tribunal, understandable that the specified persons, being caught up in the new crisis of the TRF exposures, should not have cast their minds back to the publication of the Dah Chong

Hong circular. However, Mr Peter Lee testified that he did in fact think back to the circular but at the time believed it was not necessary to seek any amendment. The Tribunal accepts his evidence in this regard. Whether, on an objective assessment, it may be held that he was correct or incorrect to come to such a conclusion, is not to the point. The point is that, taking all contemporary matters into account, it was, in the view of the Tribunal, a reasonable judgment. As Mr Peter Lee put it when he testified:

> "… in my mind, our company, CITIC, was so strong that I wouldn't imagine a so-called overexposure position of the Australian dollar in one single project would impose an MAC [material adverse change] situation on the company. And besides this kind of exposure, I was also under the impression that the Sino Iron Project was a very substantial project. We had a total investment of over US$5 billion. Any impact of the over-hedge situation should be able to be absorbed by the project. That was my thinking at that point in time."

Conclusion

376. In all the circumstances, for the reasons given, although, in parts, it has not been the easiest of matters, the Tribunal has been drawn to the conclusion that there has been a failure to prove the third essential element of section 277(1) of the Ordinance. That failure has equal application in respect of each of the specified persons and means that each must be found not culpable of market misconduct.

CHAPTER SIX

CONCLUSION

The Findings of the Tribunal

377. For the reasons set out in the body of this report, the Tribunal has been drawn to the conclusion that there has been a failure to prove the second and third essential elements of culpability under section 277(1) of the Ordinance. That being the case, it has been unnecessary to move to the fourth essential element, namely, to consider what may be called the *mens rea* issues.

378. In the result, in answering the mandate given to it pursuant to the notice dated 11 September 2014, the Tribunal has found that, in the publication of the circular on 12 September 2008, that circular being described in the report as the 'Dah Chong Hong circular', no market misconduct within the meaning of section 277(1) of the Ordinance took place. Accordingly, it must follow that none of the specified persons has been identified as having engaged in market misconduct.

A Word about the Tribunal's Limited Mandate

379. In coming to its decision, the Tribunal recognises that there may be some concern, when its decision is set against the broad sweep of the historical facts, namely:

(i) That, over a period of approximately a year, at a time of increasing and deeply ominous volatility in world markets, CITIC utilised risky derivative instruments for hedging purposes, seeking unduly to meet budgeted exchange rates that, as it proved, were never intended to be set in stone;

(ii) That, having become aware of its exposure on or about 7 September 2008, CITIC withheld making any form of announcement to the public until nearly 6 weeks later when it did so in the form of a profit warning published on 20 October 2008; and

(iii) That in the intervening period - while every effort was made to limit and/or reverse losses, efforts that were frustrated by a continuing and unprecedented global flight to safety in the US dollar - it amassed mark-to-market losses of some HK$14.7 billion.

380. What must be reiterated, however, is that the Tribunal, quite properly and in the interests of justice, was never given an unlimited mandate. As emphasised in paragraphs 73 to 76 of this report, its mandate was a restricted one. It was to determine two primary matters; first, whether market misconduct had taken place in publishing the Dah Chong Hong circular on 12 September 2008, that circular containing a statement that, at the date of publication, the directors of CITIC were not aware of any existing material adverse change in the financial position of the Group, and, second, if so, the identity of any person who had engaged in that misconduct.

381. The assertion of market misconduct made by the SFC was in fact limited to a single day; namely, 9 September 2008. On that day – the latest practicable date for amending the Dah Chong Hong circular before its

publication – it was asserted, first, that there was in existence a material adverse change in CITIC's financial position and, second, that the directors (i.e. the specified persons) knew of that change.

382. The Tribunal was never asked to assume, and nor did it assume, any form of mandate to look beyond the publication of the circular in order to enquire why it was that the decision was made within CITIC not to make any form of announcement to the public as to its continuing foreign currency exposures until 20 October 2008: more than five weeks after the publication of the Dah Chong Hong circular.

383. It must further be emphasised that the Tribunal was not mandated to look to a determination based on the concept of 'price sensitivity', a concept to be considered by way of the ordinary reasonable investor, but was instead mandated to come to a determination that took into account a separate and distinct concept, a far more rigorous one, namely, that of 'material adverse change in the financial position' of the CITIC Group.

384. This is not to suggest that, in the opinion of the Tribunal, a failure to publish any form of public announcement in the intervening period constituted any form of market misconduct. It is simply to define the limits of the mandate given to the Tribunal and to confirm that the Tribunal's findings of a lack of culpability were made within those limits.

Costs

385. In light of the findings that have been made, the Tribunal is of the provisional view that the specified persons are entitled to payment of their legal costs, to be agreed or taxed, and an order nisi is made to that effect, the

order to be made final if no prior application for a different form of order has been made within 30 days of the date of handing down of this report.

Mr. Michael Hartmann, GBS
(Chairman)

Mr Kam Jun-kow, Douglas
(Member)

Professor Tong Hin-sang, Wilson
(Member)

Dated 7 April 2017