The report of the Market Misconduct Tribunal into dealings in the shares of Evergrande Real Estate Group Limited on 21 June 2012

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

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CHAPTER 1

INTRODUCTION

Evergrande

1. Evergrande Real Estate Group Limited ('Evergrande') is a holding company incorporated in the Cayman Islands which, together with its subsidiaries, has extensive real estate interests in the Mainland of the People's Republic of China ('the PRC') including property development and construction, property investment and property management.

2. In November 2009, Evergrande was listed on the Stock Exchange of Hong Kong (stock code 3333) and at the date of this Report remains so listed.

3. By the beginning of 2012, Evergrande was one of the major property development companies in the Mainland with a broad geographical spread of operations.

4. In Evergrande's 2011 Annual Report published at the end of March 2012, its Chairman, Mr. Hui Ka Yan, wrote in buoyant terms of the Group's development activities:

> "As at 31 December 2011, gross floor area ('GFA') under construction of the Group was 36.524 million m^2 and GFA completed was 11.342 million m^2, leading the industry in construction scale and speed. The Group

continued to adhere to a rapid scale-up development strategy, newly adding 23.896 million m^2 GFA under construction for the year and having 146 projects under construction, the majority of which was available for sale within six months after the land plots were obtained. Given that there were relatively more new land reserves acquired in the first half of the year, the Group's newly constructed GFA of 14.39 million m^2 in the first half of the year was relatively larger than the 9.5 million m^2 in the second half of the year."

5. Concerning the Group's land reserves, the Chairman wrote in his Report that –

"During the year, the Group entered 41 new cities, adding 75 projects and 40.839 million m^2 of GFA, and the cost of new land reserves was approximately RMB667/m^2. The additional land reserves are located in 62 second-and third-tier cities with growth potential including, among others, Chongqing, Tianjin, Chengdu, Harbin, Lanzhou, Changchun, Hefei, Nanchang and Zhenjiang. In the first half of the year, the Group keenly seized M&A opportunities brought about by market consolidation and acquired 70 land plots, increasing the GFA of land reserves by 39.387 million m^2 from the end of 2010. In the second half of the year, the Group adhered to its fundamental strategy of "replenishing consumed land reserves" in maintaining a dynamic balance between consumption and replenishment of land reserves."

6. By way of summary, it was said that, for the year ended 31 December 2011, revenue had been RMB 61.92 billion resulting in a gross profit of RMB 20.61 billion, the Group's net profit increasing by 46.9% to RMB 11.78 billion. Earnings per share were RMB 0.761.

7. In the months following the publication of Evergrande's 2011 Annual Report, the real estate market in the Mainland experienced a degree of stress due to restrictions imposed by the PRC Central Government to curb property prices. It appears that there were also investor concerns as to Evergrande's high level of debt. Notwithstanding these factors, in the first five months of 2012 the great majority of Hong Kong market analysts were bullish as to Evergrande's prospects. By way of example:

(i) In an analysis dated 10 April 2012, Deutsche Bank, in recommending 'buy', commented that: "Evergrande is one of our top picks among the Chinese residential developers". As to Evergrande's level of debt, in a further analysis dated 21 May 2012, the headline read: "Concerns on margins/costs overdone; reiterating Buy".

(ii) In an analysis dated 29 March 2012, ICBC, recommending 'buy', commented: "Thanks to its nationwide exposure in 2nd to 3rd tier cities and excel (*sic*) in pricing strategy, the company's sales momentum remains strong despite the tough market condition. On the other hand, with 61% of the company's project not located within the purchase restriction area, sales performance will also be

less impacted by the latest purchase restriction policy. The counter is currently trading at 50% discount to our estimated NAV of HK$8.48 which we believe is inexpensive."

(iii) In an analysis dated 11 June 2012, the DBS Research Group, also recommending 'buy', said that it based its recommendation on the stock's attractive valuation and its forecast that Evergrande would continue to benefit from the "Chinese policy supporting first-time home purchase".

8. As to Evergrande's share price, it closed on the first day of trading in 2012 at $3.25, fell back a little in the rest of January and February 2012 and then began a relatively steady but unexciting rise, peaking at a closing price of $4.79 on 4 May 2012.

Events of 21 June 2012

9. More specifically, in the three months up to and including 20 June 2012, Evergrande's share price, while subject to volatility, revealed no obvious upward or downward trend. During this three-month period, it traded in a range of $3.55 to $4.81. Daily turnover ranged from between 26.7 million to 187.3 million in volume and $112.6 million to $784.9 million in value with the average being 82.2 million in shares and $351.8 million in value.[1]

[1] These figures and the assessment as to volatility have been taken from the expert report of Mr. Karl Lung dated 17 December 2014, the figures not being disputed.

10. However, on the 21 June 2012 – the date at the centre of this report – trading took on a marked difference. In early trading that day Evergrande shares moved to a high of $4.52 but then declined sharply to a day low of $3.60. This was down 19.6% from the previous day's close. The share price recovered somewhat after an announcement by Evergrande through the Stock Exchange and a tele-conference with analysts but still closed the day at $3.97, down 11.4% on the previous day's close. As a reference, the Hang Seng Index declined just 1.3% that day.

11. Equally telling is the fact that the trading volume in the shares that day reached 940 million shares. By contrast, the highest volume at any time earlier in the year had been 232 million shares, less than 25% of the volume reached on 21 June 2012. Volatility also reached new levels for the year. Previously, the highest volatility level had been 12%; on 21 June it reached 22.7%.[2]

12. What – on that day – had so significantly stimulated such a high volume of trading in Evergrande shares, trading marked by such high levels of volatility?

The Citron Report

13. It is the SFC's case that the principal – indeed, for all practical purposes, the exclusive – cause of the drop in the share price amid such a high volume of trading and such high volatility was the publication on the Internet that morning (Hong Kong time) of an in-depth analytical report which sought to

[2] These figures have also been taken from the expert report of Mr. Karl Lung, the figures not being disputed.

demonstrate that Evergrande had indulged in “fraudulent accounting” and other malpractices and was “insolvent”.

14. It does not appear that the publisher of the report was well known in South East Asia. The publisher – based in the United States – called itself Citron Research. But, whether previously known or not, allegations of such gravity, it is suggested, caused a material reaction in the Hong Kong market.

15. In what may best be described as a preview of its report (the ‘Citron Report’), Citron Research posted the following on its website:

> “This research and analysis, complied over several months, presents the conclusion that HK:3333 (Evergrande) is essentially an insolvent company that has consistently presented fraudulent information to the investing public.
>
> We prove this conclusion in the following presentation.
>
> Evergrande is not a story about the “China real estate bubble”; rather it is a tale of a company who (*sic*) has abused the capital markets as well as the generous lending of the Chinese Government in order to enrich one man, aggrandize his personal ego and support his pet projects.
>
> Bribery, excessive spending, and off-balance sheet transactions are the foundation of Evergrande’s financials.

> The situation at Evergrande is so murky that, within the last year, even the Chinese Ministry of Finance fined Evergrande for reporting inaccurate financial statements."

16. The preview continued with the following statement –

> "Citron wants to make one thing clear: we do not recommend shorting any of China's state owned banks or any construction project backed by the Government of China. On the other hand, we believe that Evergrande has misled investors and represents the worst of Chinese neo-capitalism, *and therefore represents a good short opportunity in relation to other exposure in the Chinese capital markets.*
>
> Whether it be the capital markets, government enforcement, hard or soft landing, the endgame for Evergrande is a certainty; the only uncertainty is the timing." [emphasis added]

Andrew Left

17. Citron Research is not a body corporate. It is, for want of a better phrase, a trading name, chosen by a gentleman by the name of Andrew Left. In a website posting, Citron Research introduced itself in the following terms:

> "Citron Research has been publishing columns for over 10 years, making it one of the longest-running online stock commentary websites. *With over 150 reports, Citron has amassed a track record identifying fraud and*

terminal business models second to none among any published source. All previous reports are available in the Archives tab to this site. It is obvious that the vast preponderance of companies (but not all – so who's perfect?) covered in the archived reports performed poorly as investments. Readers are welcome to compile their own track records and draw their own conclusions. [emphasis added]

The goal of this website is and has always been to provide truthful information in an entertaining format to the investing public. Our goal has never been to engage in "gotcha" journalism. Readers are always encouraged to consider this and all information available regarding any potential investments, to seek professional assistance as necessary, and to draw their own conclusions."

18. Concerning Mr. Left, the website said:

"Citron Research represents the work of a team of investigators, led by Andrew Left. Mr. Left is a private investor with 17 years trading experience. Mr. Left has been quoted in every major US financial publication, including Forbes, Fortune, Wall Street Journal, Barron's, CNBC, Investors' Business Daily, and Business Week, as well as numerous Chinese media."

19. During the course of its investigations, the SFC, acting through Mr. Stephen Herm, a Senior Counsel of the United States Securities and Exchange Commission, Office of International Affairs, was in communication

with Mr. Left. In the course of those communications, in an email dated 1 August 2012, Mr. Left said of Citron Research that it had –

> "… exposed more corporate frauds over the years than any other newsletter, analyst, or website."

20. Mr. Left's career as the publisher of reports exposing corporate malfeasance had apparently been eventful. In its website introduction Citron Research said that Mr. Left had been –

> "… sued four times by companies claiming a variety of damages as a consequence of his postings. Mr. Left has prevailed in all four of these suits. In one of the cases, *GTX Global vs Left*, the California Appeals Court, awarded him legal fees, while affirming the broad protection provided by California's Anti-SLAPP[3] law to public internet posters on topics of public interest."

21. Mr. Left had not before published any commentary on a company listed on the Hong Kong Stock Exchange. Nor is there evidence that he had ever traded in Hong Kong stocks. Why then in respect of Evergrande, did he choose to do so?

22. The uncontested evidence is that in or about March 2012, Mr. Left received a package in the United States with no return address and no material

[3] Anti-SLAPP laws ('SLAPP' standing for 'Strategic Lawsuit Against Public Participation') work in part to protect free speech in connection with public issues.

evidencing the identity of the person who had sent it. The package contained an analysis – some 68 pages long – of Evergrande. The analysis ('the draft') was formatted in the same racy 'tabloid' format that Mr. Left chose to use in his publication. It also made the same serious allegations of insolvency and various forms of accounting fraud. Although Mr. Left did not give oral testimony before the Tribunal nor submit a detailed written statement, as mentioned above, he did enter into communications with a representative of the United States Securities and Exchange Commission, Mr. Stephen Herm who was acting on behalf of the SFC. On the basis that the Tribunal has conducted an enquiry in which it is given a broad discretion as to the evidence it takes into account, it has taken note of those communications. In an email dated 1 August 2012, Mr. Left said the following:

> "After reading through the documents I believed that it was a story that should be told. After eliminating all information that could not be verified, I updated the numbers and released the report.
>
> I did not have ANYONE in China doing any of the work. Everything was pulled off the Internet and from company filings. Everything was public information; all they have to do is read my report to see that the only person who helped me with the report was one Chinese student living in the United States."

23. According to Mr. Left, he did not accept the contents of the package at face value. He went through a verification exercise, eliminating "all information that could not be verified". Not in any way being an 'insider', the material considered by Mr. Left in that verification exercise was all public

information. As he put it; it was all "pulled off the Internet and from company filings".

24. Although, as indicated above, Mr. Left had not previously published any commentary on a company listed on the Hong Kong Stock Exchange, and although he had no information as to the provenance of the package he had received containing the draft, no evidence was placed before the Tribunal to indicate that he chose to obtain expert advice on appropriate regulatory restrictions, especially applicable accountancy standards, to which Evergrande would have been subject. If what was sought was a carefully weighed, objective analysis, as opposed to one being employed essentially as a short selling weapon, the decision not to seek advice was, in the judgment of the Tribunal, a rash one.

An overview of the Citron Report

25. As said earlier, the Citron Report was presented in a hard-hitting 'tabloid' style, set out as a series of 'Power Point' presentations. The allegations made were not in any way circumspect. They spoke in bold headlines of "fraudulent accounting". They spoke of Evergrande "intentionally and systematically" hiding important financial information from investors. During the course of the enquiry, the contents of the Citron Report were described as being 'frightening' to the general investor.[4]

[4] See the testimony of Mr. Paul Phenix, an expert witness, (given on day 6): "If you were not an accountant… this would definitely frighten you."

26. The Citron Report commenced by detailing what it described as the "perception" of Evergrande, namely –

(i) That, operating primarily in second and third tier cities in the Mainland, it had grown its assets 19-fold since 2006, thereby becoming the largest home developer in China.

(ii) That its oversized and cheaply acquired land inventory had given it a competitive advantage in the market, allowing for levels of centralization and standardization that in turn allowed for unmatched cost controls and asset turnover.

(iii) That, although liquidity had tightened in the real estate sector, it remained well-capitalised and liquid.

27. The Citron Report then went on to outline what it described as the "reality", stating that its analysis and its primary research had revealed that –

> "1] Evergrande is insolvent; and 2] Evergrande will be severely challenged from a liquidity perspective."

28. The Report went on to say the following:

" • The Company's management has applied at least 6 accounting shenanigans[5] to mask Evergrande's insolvency. Our research indicates that a total write-down of RMB 71bn is required and Evergrande's pro forma equity is negative 36bn.

• Over the past 5 years, Evergrande has executed an untoward program of bribes aimed at local government officials in order to build its raw land industry. To finance growing cash flow shortfalls related to these bribes, subsequent land purchases, and related real estate construction activities, Evergrande has employed a complex web of Ponzi-style financing schemes. These schemes are characterized by reliance upon perpetually growing pre-sales, off-balance sheet partnerships and IRR guarantees to third parties.

• Evergrande's business model is unsustainable, and is showing signs of severe stress. Management is working hard to cover-up the company's precarious and rapidly deteriorating financial condition. However, with presales and condo prices now falling rapidly, with its income statement and assets materially overstated, and with its off-balance sheet guarantees looming as more and more imminent liabilities, our analysis suggests that the cover-up has entered its final inning."

29. The body of the Citron Report was divided into sections, each being described as follows:

Section 1:

"… describes Evergrande's fraudulent account schemes. These schemes enable Evergrande to mask its insolvent balance sheet.

Evergrande reports RMB 35bn of equity. We have identified six cases of accounting misstatement, where Evergrande is either overstating assets or understating liabilities. Adjusting for these misstatements, Evergrande's

[5] A 'Shenanigan' is described in the New Shorter Oxford English Dictionary (4th Edition) as "skullduggery, dubious conduct…"

pro forma equity is negative RMB 36bn. We are not the only analysts who have identified fraud at Evergrande: On October 10, 2011, China's Ministry of Finance announced that it would be fining Evergrande for reporting inaccurate financial statements."

Section 2:

"… describes large risks to Evergrande's inventory of raw land which stem from the Company's use of bribes to procure discounted land and its disregard for idle land laws in China.

Evergrande acquired its vast land inventory at a deep discount to prevailing market prices by paying bribes to local officials. Evergrande's bribing schemes are coming to light, and precedent indicates that the central government will force Evergrande to return illegally obtained land. In addition, the central government is beginning to enforce idle land laws. Evergrande risks huge fines and the loss of the vast majority of its land inventory if the government continues to enforce these laws."

Section 3:

"… outlines signs of a mushrooming financial and operational crisis at Evergrande.

We have identified 7 red flags that point to severe financial and operational stress at Evergrande."

Section 4:

"… describes Chairman Hui's bogus resume and [sketchy] financial background.

Chairman Hui has bogus credentials. Moreover, he has financed Evergrande utilizing a maze of Ponzi-esque debt and under-the-table-asset swaps."

Section 5:

"… describes the bizarre pet projects that Chairman Hui has compelled Evergrande to pursue.

Chairman Hui's pet projects are comically off-strategy and frighteningly expensive for Evergrande's shareholders. As of December 31, 2011,

> Chairman Hui has directed at least RMB 16bn (US$2.5bn) to support these bizarre, unprofitable ventures"

30. A copy of the Citron Report published on the morning of 21 June 2012 (Hong Kong time) is attached to this report as Annexure "A".

Becoming known in the Hong Kong market

31. Although Citron Research was (and is) based in the United States of America, it appears that news of its report rapidly became international. By way of example, Jason Ching, at the time a research analyst with Deutsche Bank in Hong Kong, testified that he first became aware of the report on 21 June 2012 at 10:56 a.m. when he received an email from a colleague at another investment house outside of Hong Kong. The Citron Report was attached to the email.

32. What would have been picked up by many professionals in the market – although a little later in the morning – was a cryptic Bloomberg report which appeared on the Internet at 11.04 a.m. that morning. It read:

> "June 21 (Bloomberg) -- Evergrande declines as much as 8.3%, most since March 1. ★ Mentioned negatively in note by Citron Research"

33. As for the senior management of Evergrande, it became aware of the Citron Report a little earlier than the posting of the Bloomberg report. It was about 10:30 a.m. that morning when the company's Chief Financial Officer, Mr. Tse Wai Wah, Parry, received an email from a bank in Singapore with the

report attached.

34. Evergrande's reaction, said Mr. Tse, was swift. Shortly before 1:00 p.m. that day, a 'Clarification Announcement' was published by order of the Board of Directors. It read:

> "The board of directors of Evergrande Real Estate Group Limited (the "Company") noted an institution has issued a report on 21 June 2012 (the "Report") reporting *that the Company has used accounting tricks and bribes to hide the fact that it is truly insolvent*. The Company would like to clarify that the allegation in the Report is untrue. Further clarification announcement will be made by the Company in due course. [emphasis added]
>
> Shareholders and investors are advised to exercise caution when dealing in the shares of the Company."

35. Thereafter, in the early afternoon, the Chairman of Evergrande, its CEO and Mr. Tse, the CFO, held a tele-conference with analysts from various brokerages.

36. In the result, that same day a number of leading investment houses put out detailed responses to the Citron Report criticising its contents and supporting Evergrande shares. By way of example –

(i) J.P. Morgan published an analysis under the following headlines:

"On June 21, 2012, an institution has issued a report on Evergrande, claiming that the Company has used accounting tricks and bribes to hide the fact that it is truly insolvent.

- After reviewing the report, we think that:
  - Most of the basis of the claims on misstatement of financial statement[s] are not valid in our view.
  - Most of the analysis used in the report has ignored some basic accounting standard used in the China property developers industry.
  - Most negative qualitative claims are not something new and Company has provided explanation before.
  - Stock was down 20% at one point and we believe this could be a good buying opportunity."

(ii) Deutsche Bank responded under the headline – "Accusations on solvency/liquidity look unwarranted" – by saying that it had carried out a "liquidation value analysis" and based on that analysis, it estimated Evergrande's liquidation value at close to HK$67 billion. In summary, it said:

"After the aggressive sell-off, Evergrande is trading at 64% discount to our estimated NAV (69% discount to our estimated NAV including Qidong) and 4x/3x 2012/13e earnings. Evergrande is one of our top picks among the Chinese residential developers."

(iii) UBS, in its analysis, commented:

> "We maintain our Buy rating on Evergrande and retain our price target of HK$5.5, representing a forward 6.9x FY12 PER. We considered the improving sales, cashflow and financials should help to drive the re-rating of the company. We think the near-term weakness offers good entry opportunities."

37. The following day – 22 June 2012 – a much fuller announcement was published by Evergrande, this document – 9 pages long – seeking to repudiate each of the major allegations contained in the Citron Report. A copy of this 'Second Clarification Announcement' is attached to this report as Annexure "B".

Short-selling

38. The published preview to the Citron Report (cited in paragraph 16 above) stated clearly that Evergrande presented "a good short opportunity". Nor was any secret made of the fact that Mr. Left himself may short sell the stock. In its website, Citron Research had said:

> "At any times the principals of Citron might hold a position in any of the securities profiled on the site. Citron will not report when a position is initiated or covered. Each investor must make that decision based on his/her judgment of the market."

39. At about the time of publication of the Citron Report, Mr. Left himself short-sold Evergrande shares. In this regard, the evidence revealed the following –

(i) On 11 April 2012, Mr. Left opened a securities account to allow him to trade Hong Kong stocks.

(ii) Mr. Left started to short sell Evergrande shares on 6 June 2012, his short position reaching a peak of 4.1 million shares on 19 June 2012. In respect of this trading, he had received net proceeds of $17,703,672 (after commission and tax but before share borrowing costs).

(iii) Mr. Left started to buy shares to cover his short position on 21 June 2012 – the day the publication of his report became known in Hong Kong – the 4.1 million shares purchased by him costing $15,993,116 (after commission and tax).

(iv) With the cost of share borrowing being $114,316, this left him with a net profit of $1,596,240.[6]

The SFC Notice

40. The events described above caused the Securities and Futures Commission ('the SFC') to commence an investigation into whether there had

[6] These calculations are taken from the expert report of Mr. Karl Lung.

been any form of market misconduct in relation to the shares of Evergrande.

41. As a result of that investigation, on 15 December 2014, the SFC issued a notice ('the SFC Notice') pursuant to s.252(2) and Schedule 9 of the Securities and Futures Ordinance, Cap 571 ('the Ordinance') instructing the Tribunal that –

> "Whereas it appears to the Securities and Futures Commission that market misconduct within the meaning of section 277 of Part XIII of the Ordinance has or may have taken place in relation to the securities of Evergrande Real Group Limited (Stock Code: 3333) listed on the Stock Exchange of Hong Kong Limited, the Market Misconduct Tribunal is hereby required to conduct proceedings and determine:
>
> (a) whether any market misconduct has taken place;
>
> (b) the identity of any person who has engaged in the market misconduct; and
>
> (c) the amount of any profit gained or loss avoided as a result of the market misconduct."

42. The Tribunal was required to enquire therefore whether market misconduct within the meaning of s.277(1) of the Ordinance had taken place. The requisite elements of s.277(1) will be considered later in this report. At this juncture, in order to put matters into context, it suffices to say that the

section contains four requisite elements:

(i) a person, whether in Hong Kong or elsewhere, must publish, that is, disseminate, information or be concerned in its dissemination;

(ii) the information must be likely to induce another person to buy or sell securities in Hong Kong or must be likely to maintain, increase, reduce or stabilize the price of securities in Hong Kong;

(iii) the information must be false or misleading as to a material fact, and

(iv) the person who has disseminated the information must know, or be reckless or negligent, as to whether the information is false or misleading as to a material fact.

43. S.13 of Schedule 9 to the Ordinance requires that a notice issued pursuant to s.252(2) shall specify:

> "(a) … …
>
> (b) the identity of the person, and such brief particulars as are sufficient to disclose reasonable information concerning the nature and essential elements of the market misconduct."

44. Only one person was so 'specified' in the SFC Notice, that person being Mr. Left.

45. As to the particulars of the alleged market misconduct, the SFC Notice stated as follows:

> " …
>
> 4. The Citron Report pertained to Evergrande and was negative in the sense that it stated, *inter alia*, that the company was insolvent and had consistently presented fraudulent information to the investing public.
>
> 5. The information in the Citron Report was false or misleading as to a material fact, or was false or misleading through the omission of a material fact: the company was not insolvent and nor had it consistently presented fraudulent information to the investing public.
>
> 6. The Information was likely to:
>
> (a) induce another person to subscribe for securities, or deal in futures contracts, in Hong Kong; or
>
> (b) induce the sale or purchase in Hong Kong of securities by another person; or
>
> (c) maintain, increase, reduce or stabilize the price of securities, or the price for dealings in futures contracts, in Hong Kong.
>
> 7. On 21st June 2012, the turnover of Evergrande shares was exceptionally high and the share price fell significantly."

46. As to Mr. Left's culpability – he being identified as the single 'Specified Person' – the notice asserted that –

> "The Specified Person knew that, or was reckless or negligent as to whether, the Information was false or misleading as to a material fact, or was false or misleading through the omission of a material fact.
>
> By reason of the matters aforesaid, the Specified Person has or may have contravened section 277(1) of the Ordinance and therefore has or may have engaged in market misconduct."

47. The SFC Notice was accompanied by a synopsis ('the Synopsis') setting out in greater detail the alleged conduct of Mr. Left and why it was asserted that such conduct had, or may have, constituted a contravention of s.277(1) of the Ordinance. Paragraph 9 of the Synopsis stated that the material contained, in the Citron Report was "of sufficient import to carry significant weight amongst the investing public" and went on to set out details of the trading in Evergrande shares on 21 June 2012 in support of that assertion.

48. The allegation that such material was false or misleading was detailed in paragraph 7 of the Synopsis, the paragraph stating the following:

> "Neither the materials on which Mr. Left relied (as referred to in the Citron Report) nor any other available information justified a conclusion that Evergrande was insolvent or had consistently presented fraudulent information to the investing public."

49. A copy of the SFC Notice is attached to this Report as Annexure "C". A copy of the Synopsis which accompanied the SFC Notice is attached as Annexure "D".

The limited scope of the enquiry

50. Any study of the Citron Report reveals a very large number of criticisms of Evergrande, either independent or inter-locked with other criticisms. In bringing these proceedings, the SFC did not seek to demonstrate that every last allegation made in the Report was false or misleading as to a material fact: a task of considerable complexity and magnitude. As often happens, the Regulator chose to focus on limited aspects of the Citron Report, in this instance on two specified areas –

(i) that part of the Citron Report which asserted that in its public financial statements Evergrande had been culpable of 'fraudulent accounting'; that is, of presenting fraudulent information to the investing public, and

(ii) that part of the Citron Report which stated that in reality Evergrande was insolvent.

51. It was the SFC case that these two assertions were false and/or misleading as to material facts, the first material fact being that Evergrande had not been culpable of "fraudulent accounting" but, to the contrary, had presented its accounts in accordance with prevailing accountancy standards without in any

way using the complexity of those standards to dishonestly disguise its true financial position; the second material fact being that Evergrande was not, nor had been, insolvent. It was further the SFC case that these false and/or misleading facts were – of themselves – of such significance that, once known, they were likely to have an impact on the market.

52. The SFC did not, by limiting its case, concede that the balance of the Report was neither false nor misleading.

53. In this regard, the Tribunal is satisfied that it was not incumbent on the SFC, in bringing it disciplinary action, to allege that the entire report was false or misleading. S.277(1) speaks only of the dissemination of "information". Such "information" may constitute an entire publication or part of it.

54. If, however, the "information" is only part of a greater whole – as in the present case – it must be considered in context. There are two reasons for this. First, because, when read in context, it may not be false or misleading as to a material fact. Second, when read in context, it may not – of itself – constitute information likely to effect the price of securities or induce dealing in them.

Events following service of the SFC Notice and Synopsis

55. After service of the SFC Notice and Synopsis, and after time had been allowed for Mr. Left to retain and instruct legal representation, a first directions hearing was held on 18 March 2015.

56. During the course of the enquiry, the Presenting Officer, and leading counsel for the SFC, was Mr. Peter Duncan SC while Mr. Left was represented by Mr. Laurence Li.

57. Concerning the commencement of the substantive enquiry hearing, as the Chairman and both leading counsel were already extensively committed, the hearing could only be set to commence some 11 months ahead on 22 February 2016.

58. A second directions hearing took place on 18 September 2015. At that hearing, Mr. Li, on behalf of Mr. Left, confirmed that a notice had been filed with the Tribunal in terms of which extensive discovery of documents in the possession of Evergrande was sought. That application was opposed by Mr. Duncan, the Presenting Officer.

59. In the result, the application for discovery was argued before the Chairman on 30 September 2015. In terms of a ruling dated 27 October 2015, the application was refused. More is said of the application for discovery and the Tribunal's ruling in Chapter Two.

60. The substantive enquiry hearing commenced, as scheduled, on 22 February 2016, concluding on 3 March 2016.

61. Because of the novelty and complexity of many of the submissions to be made on behalf of Mr. Left, it was directed that the submissions would be

filed in writing, the 10 June 2016 being set aside to enable counsel to speak to those submissions. Final oral submissions were heard by the Tribunal on that date.

CHAPTER 2

THE AMBIT OF THE EVIDENCE TO BE INTRODUCED INTO THE ENQUIRY

The Ruling of 27 October 2015

62. As stated earlier in this report[7], on 17 September 2015, the Specified Person, Mr. Left, filed an application for discovery of documents said to be in the possession or under the control of Evergrande. That application was opposed. The matter was argued before the Chairman of the Tribunal on 30 September 2015.

63. In terms of a Ruling handed down on 27 October 2015, the application for discovery was refused. A copy of that Ruling is attached to this Report as Annexure "E".

64. As described in the Ruling, Mr. Left's application was to the following effect:

> "On behalf of Mr. Left, his counsel, Laurence Li, submitted that, on the basis of the SFC case, the central issue for determination by the Tribunal would be whether the information disseminated by Mr. Left in the report was in fact false or misleading or, put another way, contrary to what Mr. Left had published, "whether Evergrande was actually solvent and

[7] See paragraphs 58 and 59 of this report.

> whether in fact it had been presenting true accounts". This, submitted by Mr. Li, required an enquiry into Evergrande's true financial position and in turn this demanded a review of its records and documents. It was for this reason, said Mr. Li, that an order for production of relevant records and documents was being sought. The exact terms of the order – or perhaps successive orders – would be subject, of course, to the guidance of the Tribunal."

65. Mr. Li, on behalf of Mr. Left, recognised that locating all relevant documents in their various places of storage and thereafter conducting a coherent study of them would be a major undertaking. But he saw no alternative. As recorded in the Ruling, his submissions in this regard were to the following effect:

> "The SFC, he said, relied on three matters of evidence in order to prove its case. First, it relied on the audited financial statements of Evergrande; second, it relied on certain analyst reports which themselves assumed the truthfulness and completeness of the audited financial statements and, third, it relied on an expert opinion, that expert also assuming the truthfulness and completeness of the audited financial statements. In short, at the end of the day everything was reduced to the audited financial statements. Audited financial statements, however, said Mr. Li only went so far. Audited financial statements were not themselves proof that there had been no fraud. Fraudulent activities were often – perhaps invariably – hidden from the auditors.

> In addition, as Mr. Li put it, when a research report sets out an analysis of the finances of a company and the report is drawn to the conclusion that the company is essentially insolvent and/or has been presenting fraudulent information to the public, this means, of course, that the report calls into question the degree of assurance that the relevant audits are capable of giving. Accordingly, "citing the audited figures is no logical answer. It is not even meeting the point." That being the case, there was only one way to determine whether the information disseminated by Mr. Left in the reports was false or misleading, that was to look *beyond* the audited statements into primary documents: hence the request for an order for the production of relevant documents …"

66. In reply, Mr. Peter Duncan SC, the presenting officer, submitted as recorded in the Ruling, that the SFC case –

> "… did not require that there be a return to the fountainhead of Evergrande's primary documents. The matter fell to be determined on the basis only of what information was in the public domain at the time of the report. It was *that* information which Mr. Left used to compile his report and it was accordingly on *that* information that his culpability should be determined."

67. That Mr. Left had only relied on information in the public domain, was confirmed by him personally in his note of 1 August 2012 addressed to Mr. Stephen Herm[8]. To repeat, the note said:

[8] See Chapter 1, paragraph 22.

> "I did not have ANYONE in China doing any of the work. Everything was pulled off the Internet and from company filings. Everything was public information…"

68. In paragraph 7 of its Synopsis, the SFC had stated in clear terms that its case was also based on public information only:

> "Neither the materials on which Mr. Left relied (as referred to in the Citron Report) nor any other available information justified a conclusion that Evergrande was insolvent or had consistently presented fraudulent information to the investing public".

69. Mr. Duncan submitted therefore that the SFC case did not depend –

> "… on the production of the myriad documents that lie behind the published audited financial statements of Evergrande. The SFC case is limited to the assertion that Mr. Left created false or misleading information out of what was publicly known about the corporation at the time. Any defence, he said, was to be similarly restrained."

70. The Tribunal dismissed Mr. Left's application. In giving its reasons, *inter alia,* the Tribunal said –

> "At the time when Mr. Left compiled his report – as a market commentator and not an 'insider' – the only information available to him was information in the public domain. It was that information that he used as the basis for

> asserting that Evergrande was for all practical purposes insolvent and that it had consistently presented fraudulent information to the investing public. The SFC is therefore obliged to present its case on the basis of that information just as Mr. Left is obliged to do so."

Final submissions: denial of an opportunity to be heard

71. At the end of the enquiry, in final submissions, Mr. Li returned to the issue, this time on the basis that his client should have been given access to the underlying evidence and that the failure to give him such access denied him a reasonable opportunity of demonstrating that, whatever the evidential basis upon which the Citron Report had been based, if his findings of fact – upon investigation of material not in the public domain – turned out to be true then there would be no falsity and no case to answer. On this basis it was submitted that, by denying Mr. Left any degree of access to underlying evidence, he had been denied a reasonable opportunity of being heard and should not therefore be identified as having engaged in market misconduct.

72. In this regard, Mr. Li returned to the core allegation made by the SFC, namely –

> "The information in the Citron Report was false or misleading as to a material fact, or was false or misleading through the omission of a material fact: *the company was not insolvent and nor had it consistently presented fraudulent information to the investing public*." [emphasis added]

73. It was ‘extraordinary’, said Mr. Li, that the SFC should take such a position, inviting the Tribunal to make a finding of fact that Evergrande’s accounts were genuine.

74. The Tribunal, however, has not viewed the SFC case in that light.

75. It is to be emphasised that the purpose of s.277 is to protect the investing public by ensuring that information placed before it is not false or misleading as to a material fact. It is *that* information, published at *that* time in respect of what was known at *that* time that the investing public will be aware of and may act upon.

76. In publishing the Citron Report, Mr. Left made no assertion that he possessed inside information, indeed, he asserted that everything that he verified he did so by having regard to information in the public domain. Accordingly, in seeking to demonstrate the deficiencies in the Citron Report as to the issues of “insolvency” and “fraudulent accounting” the SFC has based its case on the same basis, namely, on information available in the public domain at the relevant time.

77. The issue, therefore, that has fallen for determination in this enquiry is whether, on the basis of what was known to the Citron Research Team and to the market at the time, information was published that was likely to have an impact on the market (in respect of dealing in Evergrande securities) and whether that information has been demonstrated to be false or misleading as to material facts.

78. In the view of the Tribunal, the determination of these issues pursuant to s.277 does not require the effectively impossible exercise of working through Evergrande's archives to have sight of its (no doubt) vast repository of primary documents, financial and commercial.

The Ruling of 23 February 2016

79. Finally, it is to be mentioned that a second application was made by Mr. Li at the commencement of the enquiry hearing on 22 February 2016. On this occasion, Mr. Li sought an order amplifying the order made pursuant to the ruling of 27 October 2015. It was submitted that, as Mr. Left's culpability fell to be determined on the basis only of what information was in the public domain at the time he published his report, the Tribunal should refuse to consider any evidence arising after publication of his report.

80. In the Tribunal's second ruling given the following morning – a copy of this second ruling being attached to this Report as Annexure "F" – the application was refused. In so doing, the Tribunal found that –

> "… the narrow question to be asked is as follows: whatever its provenance or timing, is the evidence probative of whether, judged on the materials in the public domain at the time of publication of the report, Mr. Left disseminated false or misleading information? If so, *prima facie*, the evidence may be heard."

CHAPTER 3

DIRECTIONS AS TO LAW

The requisite elements of s.277(1) of the Ordinance

81. S.277(1) states as follows:

> "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."

82. It was not disputed that s.277(1) contains four requisite elements each of which must be proved in order to prove market misconduct. Those four elements, summarized earlier in this report, are as follows:

(i) a person, whether in Hong Kong or elsewhere, must publish, that is, disseminate, information or be concerned in its dissemination;

(ii) the information must be likely to induce another person to buy or sell securities in Hong Kong or must be likely to maintain, increase, reduce or stabilize the price of securities in Hong Kong;

(iii) the information must be false or misleading as to a material fact; and

(iv) the person who has disseminated the information must know, or be reckless, or negligent, as to whether the information is false or misleading as to a material fact

The first requisite element: the specified person must disseminate the information or be concerned in its dissemination

83. There is nothing in this first requisite element that requires a direction as to law or an explanation of terminology. As it is, it was never disputed that Mr. Left headed the team that produced and published the Citron Report or, at the very least, that he took a leading role in its production and publication.

The second requisite element: the information must be likely to induce others to deal in shares in Hong Kong

84. In respect of this element (which has a broad factual coverage), the only word that requires any explanation is 'likely'. If information is likely to induce others to a course of action, it is 'probable' that it will do so; put another way, there is a real chance it will do so and not a remote chance.

The third requisite element: the information must be 'false or misleading', as to a 'material fact'

85. As to the language of this element –

(i) The word 'false' is plain enough. It means 'untrue'. The word 'misleading' is also plain enough. It means to cause an incorrect impression. If information is 'misleading', it is information that is inconsistent with the true state of affairs.[9]

(ii) For the purposes of this report, a 'fact' may be said to be an item of verified information, that is, the independent reality of a matter as opposed to an opinion concerning it. It is important to recognise the difference between an asserted fact and a comment concerning it.

[9] See *Asic v. McLeod* (2000) 34 ACSR 135

(iii) A ‘material fact’ is a fact that is sufficiently significant to influence a reasonable person to take a course of action, for example, in the present case, to deal in Evergrande shares. It is to be contrasted with an ‘immaterial fact’, one that is unimportant and would not reasonably influence a course of action.

The fourth requisite element: knowledge, recklessness, negligence

86. The fourth element requires it to be proved that, when Mr. Left published the Citron Report, he knew that the information in it which is the subject of the SFC proceedings was false or misleading, or he was reckless or negligent as to whether it was so.

(i) Knowledge

87. In respect of knowledge, it need only be said that nothing short of actual knowledge suffices.

88. During the course of submissions, it was said that a person may know something if he shuts his eyes to the obvious. What must be emphasised, however, is that this is not a dilution of the straightforward concept of knowledge. It merely takes into account those circumstances in which it is proved that a person knows the truth but by way of a façade seeks not to have confirmed what he already knows.

89. The test as to knowledge may therefore be formulated as follows. When he published the Citron Report, did Mr. Left know that the information which is the subject of these proceedings was false and/or misleading?

(ii) Recklessness

90. By way of an introduction, it can be said that recklessness describes the state of mind of a person who pursues a course of action consciously disregarding the fact that it gives rise to a real and unjustified risk.

91. In Hong Kong, in respect of criminal law, the concept of recklessness has been defined by the Court of Final Appeal in the following terms:

> "… it has to be shown that the defendant's state of mind was culpable in that he acted recklessly in respect of a circumstance if he was aware of a risk which did or would exist, or in respect of a result if he was aware of a risk that it would occur, and it was, in the circumstances known to him, unreasonable to take the risk. Conversely, a defendant could not be regarded as culpable so as to be convicted of the offence if, due to his age or personal characteristics, he genuinely did not appreciate or foresee the risks involved in his actions."[10]

92. The test is a subjective one, going to a person's state of mind. In the present case, the test may be formulated in the following three questions:

[10] See *Sin Kam Wah v. HKSAR* (2005) 8 HKCFAR 192

(a) When Mr. Left came to publish the Citron Report, was he aware of the risk that the information in it which is the subject of these proceedings was false and/or misleading?

(b) Was Mr. Left further aware that in the circumstances the risk was of such substance that it was unreasonable to ignore it?

(c) Did he nevertheless, although aware of (a) and (b) above, go ahead and publish the Citron Report?

If the answer to each of the three questions is 'yes' then he was reckless.

93. In the course of submissions, it was suggested by Mr. Li on behalf of Mr. Left that the definition of recklessness defined by the Court of Final Appeal and cited above, while appropriate in respect of general crimes, may be difficult to apply in the context of financial and business matters. Mr. Li put forward alternative formulations including the definition employed in cases of misrepresentation in common law, namely, that recklessness amounts to an indifference to the truth, not caring whether a statement is true.

94. The Tribunal is satisfied, however, that the formulation of the three questions set out in paragraph 92 above is not only a reflection of the definition of the Court of Final Appeal but is also in the present case a workable formulation, one that incorporates the common law concept of indifference to the truth.

(iii) Negligence

95. As with the term 'recklessness', the term 'negligence' is not defined in the Ordinance. Neither term therefore is to be understood within the confines of s.277(1) as being a particular term of art. The relevant subsection does no more than list the three states of mind upon which the culpability of a person is founded: knowledge, recklessness, negligence. That being the case, it would appear that, just as the concepts of knowledge and recklessness are to be given their ordinary meaning, so must the concept of negligence.

96. Expressed succinctly, the concept of 'negligence' has been defined as "the failure to exercise that care which the circumstances demand."[11]

97. In contrast to recklessness, a subjective concept in which the state of mind of an individual is sought to be ascertained, the concept of negligence is an objective one, being judged through the eyes of the 'reasonable man'. This has been well expressed (in whimsical fashion) in the following Canadian dictum which has defined negligence as –

> "… the failure, in certain circumstances, to exercise that degree of foresight which a court, in its aftersight, thinks ought to have been exercised. The proper standards of foresight and care are those attributed by a court to a reasonably careful, skillful person. The ideal of that person exists only in

[11] See *Carmarthenshire County Council v Lewis* [1955] 1 All ER 565 (HL)

> the minds of men and exists in different forms in the minds of different men. The standard is therefore far from fixed as stable. But it is the best all-round guide that the law can devise…"[12]

98. As Presenting Officer, it was Mr. Duncan's submission that, giving the concept of negligence its ordinary meaning, s.277(1) imposed upon all persons a positive duty to take reasonable care before disseminating information to the market to ensure that it was true and not misleading.

99. On behalf of Mr. Left, Mr. Li took a more restrictive view. It was his submission that, pursuant to the provisions of s.277(1), negligence was not properly to be read as applying to all persons but only to those persons who, by their actions, had an existing duty and a standard of care to meet.

100. Mr. Li argued that the unqualified use of the word 'negligent' in s.277(1) had to be read in accordance with the presumption that a statute is to be understood as being consistent with the common law unless clearly indicated otherwise. The common law position as to economic loss arising from reliance upon a negligent statement is based upon a relationship between the statement maker and the person who relies upon it. As it was put by Lord Goff in *Henderson v Merrett Syndicates Limited*[13].

> "… if a person assumes responsibility to another in respect of certain

[12] See *Carlson v Chochinov* [1947] 1 WWR 755 at 759

[13] [1995] 2 AC 145 at 181

> services, there is no reason why he should not be liable in damages in respect of economic loss which flows from the negligent performance of those services .”

101. Accordingly, said Mr. Li, it was implicit that, if a person was to be found liable under s.277(1) on the basis of negligence, it had to be demonstrated that the person stood in special relationship to the market, for example, being the director of a listed company, or had assumed a special relationship to the market, for example, by way of being a licensed analyst.

102. On behalf of Mr. Left, it was emphasised that he was not a licensed person in Hong Kong (or elsewhere). He was not a director, officer, substantial shareholder or in any way an ‘insider’ in respect of Evergrande. In that respect, it was argued, he simply owed no duty of care. Nor did he hold himself out as having any special accountancy qualifications in Hong Kong. He therefore occupied no special position in respect of the Hong Kong market, either in law or fact.

103. Absent any duty of care, if his analysis revealed that he did not have a proper understanding of the Mainland property sector, his views could be rejected.

104. In part support of his submissions, Mr. Li made reference to an assurance given by the Administration to the Legislative Council when section 391 of the Ordinance was under consideration. That section imposes civil liability on a person who is responsible for a communication concerning

securities or futures contracts, the communication being made or issued to the public or to a group of persons comprising members of the public. The assurance was to the following effect:

> "We have discussed with the Bar Association… and have clarified that the provision is not intended to go further than the common law."

105. Logically, said Mr. Li, the same 'clarification' must apply to s.277(1). Whether that is or is not the case, the Tribunal does not see that it takes the matter of interpretation any further. S.277(1) imposes liability on any person who disseminates false or misleading information that is likely to have an impact on the market just as s.391(1) imposes liability on any person who makes a communication to the public, that is, to people at large, or to any group of persons comprising members of the public. Neither provision sits happily with the concept advocated by Mr. Li of the necessity of an *existing* duty and standard of care. In the view of the Tribunal, the duty of care – in respect of both sections – is a duty that is created by the statute itself.

106. Mr. Li sought to bolster his submission that only those persons who had assumed a particular responsibility to the market, and who therefore stood in a special relationship to it, could have liability imposed upon them pursuant to the concept of negligence by arguing that this more restrictive, but nevertheless purposive, interpretation would better protect the fundamental right of freedom of expression. In this regard, he emphasized that s.277(1) clearly impinged on the fundamental right to freedom of expression and therefore had to be interpreted in accordance with the following three principles. First, that

fundamental rights are to be interpreted generously; second, that any restrictions on fundamental rights are to be interpreted narrowly and; third, that it is for the Government to bear the burden of justifying any restriction.

107. The Tribunal has incorporated these three principles into its interpretation of the concept of negligence as contained in s.277(1). However, it is satisfied that, on a purposive interpretation, one in which words are given their natural and ordinary meaning unless the context or purpose points to a different meaning, the section can only be read as applying to *all* persons who choose to disseminate information that is likely to have an impact on the market, that choice imposing a duty of care upon them to ensure that such information is not materially false or misleading.

108. In this regard, it is to be remembered that the section speaks of ‘a person’ who disseminates information or is concerned in that dissemination. ‘A person’ must mean ‘any person’.

109. It is further to be remembered that, on an ordinary construction of the section, the three concepts of knowledge, recklessness and negligence appear in sequence and, in the judgment of the Tribunal, must be understood as constituting a hierarchy of culpability in terms of which the state of mind of actual knowledge is the most serious while carelessness, that is, negligence, is the least serious.

110. The Tribunal has difficulty in seeing how the section can be interpreted so that ‘any person’ can be held liable on the basis of actual

knowledge or recklessness but, in respect of the least culpable state of mind, an additional requisite element must be imposed, namely, that of establishing some existing special relationship.

111. If it is suggested that the concept of some existing 'special relationship' must be proved in respect of each of the three alternative states of mind then it would follow that a person who had assumed no such 'special relationship' would be at liberty to publish assertions as to material facts knowing that they would be likely to have an impact on the market and knowing that they were false or misleading: an open invitation to sabotage. In the view of the Tribunal, that cannot be a correct purposive interpretation of the section. It is to be remembered that the right of freedom of expression is not an absolute right. Everyday, for example, journalists – who themselves have no 'special relationship' to their subjects – are called upon, before publishing a contentious story or article, to confirm the limits of their freedom.

112. As stated earlier, the Tribunal is satisfied that, in complying with the common law, s.277(1) imposes a duty of care on all persons who choose to disseminate, or be concerned in the dissemination, of information that is likely to have an impact on the market. That duty of care is owed to the market.

113. In this regard, the Tribunal has looked to the basis upon which the Administration supported the passage of the Securities and Futures Bill through the legislative process by maintaining that:

> "… false or misleading information has a very serious effect on the price of securities or futures contracts which may cause immediate harm to a large number of investors and disruption in the market. The provisions are intended to protect the interests of investors and to maintain an orderly market. The Administration is of the view that it is reasonable to impose *on those involved in disclosing information that might have an effect on investment decisions* a duty to take reasonable steps to ensure that such information is true and not misleading."[14] [emphasis added]

114. Concerning the justification in Hong Kong for the restriction on the fundamental right of freedom of expression, the Tribunal is of the view that Mr. Duncan's submission correctly states the justification. The aim of the legislation, he said, "is to maintain the integrity of the markets and to protect the public at large from the potentially very damaging effects of false or misleading information. This is a legitimate aim which serves to protect economic order, a subset of the broader principle of *ordre public*."

115. Nor can it be said that Hong Kong alone has chosen to legislate in this manner in order to protect the legitimate interests of financial markets. The Tribunal was informed that legislative provisions to like effect are to be found in Australia, the United Kingdom and the United States. By way of example, s.1041E of the Australian Corporations Act 200, in seeking to protect against the same mischief as s.277(1), imposes liability on any person who "knows, or *ought reasonably to have known*, that the statement or information is false in a

[14] The Report of the Bills Committee of 5 March 2002 [paragraphs 128 – 129]

material particular or is materially misleading."[15]

116. The Tribunal would add that, while s.277(1) imposes a duty of care on all those who choose to disseminate, or be concerned in the dissemination, of information which is likely to have an impact on the market, the section is not entirely open ended. First, the information must be shown to be false and/or misleading as to a material fact, that is, a fact and not simply an expression of opinion, and, in addition, a fact of significance. Second, the information must be shown to be likely to induce others to deal in the market of Hong Kong; in short, in the context of this enquiry, it must be demonstrated that the information is likely to be influential.

117. As stated earlier, negligence has been defined as "the failure to exercise that care which the circumstances demand". That, of course, raises the question: how is the level of care demanded by the circumstances to be assessed? In short, what is the standard of care in the present case?

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[15] S.1041E of the Australian legislation reads:

"(1) A person must not (whether in this jurisdiction or elsewhere) make a statement, or disseminate information, if:

(a) the statement or information is false in a material particular or is materially misleading; and

(b) the statement or information is likely:
(i) …
(ii) …
(iii) to have the effect of increasing, reducing, maintaining or stabilizing the price for trading in financial products on a financial market operated in this jurisdiction; and

(c) when the person makes the statement, or disseminates the information:
(i) the person does not care whether the statement or information is true or false; or
(ii) the person knows, or ought reasonably to have known, that the statement or information is false in a material particular or is materially misleading."

118. The Tribunal accepts that the standard of care to be applied must be a realistic standard not an ideal one. In this regard, the following dictum of Laws LJ (albeit in respect of a road traffic case) is instructive:[16]

> "There is sometimes a danger in cases of negligence that the court may evaluate the standard of care owed by the defendant by reference to fine considerations elicited in the leisure of the court room, perhaps with the liberal use of hindsight. The obligation thus constructed can look more like a guarantee of the claimant's safety than a duty to take reasonable care."

119. As to the appropriate standard of care to be applied in this particular case, it was Mr. Duncan's submission that the standard was to be judged by asking: "What would a reasonable person engaged in the activity of writing and disseminating a research report in which grave allegations of insolvency and fraudulent accounting are made" have done to seek to ensure it did not contain materially false or misleading information?

120. Again, Mr. Li sought a more restrictive interpretation. In this regard, he cited *Charles Worth and Percy on Negligence*, 13th ed., 7-07:

> "… to say that the standard of care is that of a reasonable man can be to beg the question. A tribunal of fact can only be directed to apply the standard of reasonable care if it is explained what amount of care the law regards as reasonable under the circumstances of the case being tried. If reasonable care alone were the only test, the following pages would be superfluous."

[16] See *Ahanonu v South East London and Kent Bus Company Limited* [2008] EWCA Civ 274, para 23.

121. Mr. Li qualified this by making the uncontentious submission that the standard of care – an objective standard – must be judged by looking to the activity and not to the individual characteristics of the actor, that is, the person carrying out the activity. In this regards, Mr. Li emphasised the following:

(i) The activity carried out by Mr. Left was that of "stock commentary", an activity engaged in by a broad spectrum of members of the public requiring no licence nor appointment. It was not a commentary based on inside information or a close relationship with the management of a public company, for example, the kind of relationship enjoyed by licensed analysts[17].

(ii) This kind of activity, said Mr. Li, that is, short-seller stock commentaries, played any important role in the market. Mr. Li put it this way:

> "The securities market thrives on free flow of information – positive and negative information. Its very function is to assess the information. It is generally better at the task than any government agency or, with due respect, judicial body.
>
> This is especially true when the market assesses what a short-seller says. A short-seller is the quintessential outsider. He has no access to inside the company. Whatever analysis he shares with the market is transparent. The market can see and judge for itself the basis,

[17] Who are invariably 'sell side' analysts holding a Type 4 licence under s.114 of the Ordinance.

limitations, and reasoning."

(iii) Mr. Li emphasised that the market values diversity and "understands that there will be extremists".

122. In light of such considerations, said Mr. Li, a standard of care in respect of the kind of activity carried out by Mr. Left should be formulated as follows; namely, that a person who comments only on information in the public domain has a duty:

(i) to make clear that his comments are derived from public information only so that the public knows he does not claim special knowledge; and

(ii) set out the public information from which he derives his comments so that the public can decide whether they agree or disagree.

123. Such a test, said Mr. Li, was clear, easy to apply and predictable. Let the market determine the matter.

124. The Tribunal is unable to accept this proposed formulation. On this basis, provided a commentary declares that it is based solely on information in the public domain and sets out that information, it can, with impunity, draw conclusions that are false or misleading by reason of negligence. That would fundamentally undermine the protective purpose of s.277(1).

125. Mr. Li argued that the market is robust and has the ability to sift information of no value from information that can properly be relied upon. In this respect, he quoted the observation of the American jurist, Holmes J, that "the best test of truth is the power of thought to get accepted in the competition of the market."

126. That may be so when one valid intellectual concept is set against another but, bearing in mind the speed and fluidity of financial markets, there must always be a danger that false or misleading information, especially as to complex issues, may have a materially detrimental impact on the market before its true nature is understood and becomes known.

127. Accordingly, bearing in mind that it is not possible to set one clearly articulated standard for the multitude of circumstances that arise in the day-to-day workings of the financial markets, the Tribunal is satisfied that, in respect of the present case, the test as to negligence may be formulated as follows. In compiling and publishing the Citron Report, did Mr. Left exercise that level of care to avoid the inclusion of false or misleading information as to material facts that is realistically required of a reasonably prudent person carrying out the function of a market commentator and/or analyst?

The burden of proof and standard of proof

128. The SFC bore the burden of proof. In respect of the standard of proof, s252(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."

129. 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."[18]

Good character

130. Market misconduct, though not criminal in nature, is a serious finding against an individual. In the circumstances, although Mr. Left did not make a witness statement filed in these proceedings or give evidence in these proceedings, the Tribunal has recognized that, as a person of good character, he was less likely than otherwise might be the case to have committed the alleged misconduct.

The drawing of inferences

131. In so far as it has been necessary for the Tribunal to come to determination by way of drawing inferences, the Tribunal has directed itself that

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

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

132. During the course of the enquiry, the Tribunal received evidence from two expert witnesses.

133. Mr. Karl Lung Hak Kau ('Mr. Karl Lung') who, as a market expert, gave his opinion, first, as to whether the information contained in the Citron Report was likely to impact on trading in Evergrande shares and who, second, conducted an analysis of Mr. Left's trading in Evergrande shares in June and July 2012.

134. Mr. Paul Anthony Phenix ('Mr. Paul Phenix') who, as an accounting and financial reporting expert, conducted a review of the Citron Report in order to give his opinion as to whether the Report was materially false or misleading in respect of its assertions that Evergrande had engaged in fraudulent accounting and that it was insolvent.

135. The Tribunal received the evidence of both witnesses – as to both the information given by them and the expressions of opinion made – because it was likely to be outside the experience and knowledge of the Tribunal. The

evidence, however, was received on the basis that the Tribunal was entitled to accept or reject all or part of that evidence in reaching its own conclusions based on its assessment of all the evidence.

CHAPTER 4

THE FIRST AND SECOND REQUISITE ELEMENTS OF S.277(1)

The element of dissemination of the relevant information, namely, that Mr. Left was concerned in posting the Citron Report on the Internet

136. This element requires it to be proved on a balance of probabilities that Mr. Left, whether in Hong Kong or elsewhere, was concerned in the publication of the Citron Report, that is, in its compilation and dissemination on the Internet.

137. During the course of the enquiry it was never disputed that Mr. Left – at all times apparently resident in the United States – headed the research team that prepared the Citron Report and that he authorized its dissemination on the Internet by giving the relevant instructions. In his written closing submissions, Mr. Li, on behalf of Mr. Left, confirmed that this first requisite element was not disputed.

The element of 'likely' market effect, namely, that it was probable that the Citron Report would have an impact on the market by inducing the sale or purchase of Evergrande shares in Hong Kong

138. This element requires the determination of a predictive test, the test being an objective one. The Tribunal is required to ask itself not whether the posting of the Citron Report on the Internet did have an impact on the market in Hong Kong by inducing the sale or purchase of Evergrande shares, it is instead

required to determine whether, having regard to all relevant factors, it was probable at the time when the Citron Report was posted that it would have such an effect. In the present case, the distinction is of importance.

139. Mr. Li placed emphasis on the distinction by posing the following question. In the months leading up to the publication of the Citron Report, even in the days immediately before, numerous "big-name investment banks" had published uniformly positive reports on Evergrande. How likely was it then – in the face of such bullish reports – that the information contained in the Citron Report would have any impact on the Hong Kong market, remembering that the publisher was (for all intents and purposes) unknown in Hong Kong and had never before commentated on Hong Kong securities? The fact that it may have had an impact was a matter of chance not a matter of probability. As such, whatever the actual consequence of posting the Citron Report on the Internet, the second requisite element of s.277(1) had not been established.

140. In determining this matter, two questions arise. First, was it probable that the Citron Report would have become known in the Hong Kong market? Second, even if it did become known, was it probable that it would have an impact on the market of sufficient consequence?

141. In determining the first question, it is to be remembered that, while there was no evidence that Citron Research (and Mr. Left) was on 21 June 2012 in any way generally known in Hong Kong, the probabilities suggest that this state of ignorance was not universal. To the contrary, on the evidence put before the Tribunal, it appears that Citron Research had by that time established

a certain reputation for itself, certainly within the United States. By way of self-promotion, the Citron Research team said of itself that –

> "Citron Research has been publishing columns for over 11 years, making it one of the longest-running online stock commentary websites. With over 150 reports, Citron has amassed a track record identifying fraud and terminal business models second to none among any published source."

142. Concerning Mr. Left himself, he made no attempt to hide the fact that he had successfully resisted court actions brought against him on a number of occasions and that in some 17 years of trading he had been quoted in many influential financial publications in the United States. On the evidence, it appears that Mr. Left had sought (and had secured) a reputation as a 'crusader'.

143. On his behalf, it was emphasised that he had done nothing on this occasion to advertise or promote the Citron Report to the Hong Kong market. The Tribunal accepts that to be the case. But that said, bearing in mind that Mr. Left had set in motion a short-selling exercise to coincide with the publication of the Citron Report, it seems to be counter-intuitive to think that Mr. Left did not expect any reaction from the Hong Kong market.

144. Mr. Karl Lung was called by the SFC as an expert witness, part of his instructions being to give his opinion as to whether the Citron Report was likely to become known to the Hong Kong market and, if so, its likely impact. In the course of his testimony, Mr. Lung accepted that at any one point in time there were no doubt many stock commentators, analysts and the like seeking to build

a reputation over the Internet. Often they were not successful and were lost in the void. That of course is true. But, in the view of the Tribunal, it is equally true that those with an established reputation – especially when that reputation involves a degree of notoriety – are far more likely to be given attention. Bearing in mind the reputation already secured by Citron Research, the Tribunal does not find it surprising that an attack by it on a prominent listed company in Hong Kong should have alerted professional market players, relatively more sophisticated investors and general investors.

145. No doubt initially attention would have come from sources in the United States. It is a truism, however, that financial markets are today – and were at the relevant time – global in nature, information being the principal driver. In such circumstances, the Tribunal does not find it surprising that within hours of the Citron Report being published, bearing in mind the history of Citron Research and its notoriety, that it should have come to the attention of finance houses, banks and the like and, instead of being ignored, should have been passed on to those operating in the Hong Kong market.

146. What must also be remembered is that the very nature of the Citron Report demanded attention. During the course of the enquiry it was described as being 'sensationalist' and even, for ordinary investors, "frightening'. A headline that proclaims in respect of a prominent listed corporation: "fraudulent accounting masks insolvent balance sheet" raises two immediate fundamental concerns for any investor – fraud and insolvency, a spectre perhaps of total loss. Nor could it be said that the Citron Report was a thin document, lacking apparent support, one that could easily be ignored.

147. In the circumstances, the Tribunal has had no difficulty in coming to the conclusion that, even without any form of promotion, it was likely – indeed, almost inevitable – that the Citron Report would have become known to the Hong Kong market within a very short time of its publication.

148. What then of the second question: was the Citron Report, once known, likely to have an impact on the market by inducing others to deal in Evergrande shares?

149. In his report, Mr. Karl Lung said that in or about June 2012, although the real estate market in the Mainland had been experiencing some stress due to the implementation of government policy to curb property prices, and although there was some concern as to Evergrande's high level of debt, the general investing public did not appear to consider these risks to be significant. While there was volatility in the share price, he said, no downward trend was observed in the three months prior to the issue of the Citron Report.

150. Nor, on the available evidence, was the Tribunal made aware of any notable developments in or about June 2012 that would have caused concern as to Evergrande's worth. To the contrary, as mentioned earlier in this report, many bank analysts were heading their reports with a "buy' recommendation.

151. As to those persons accustomed to dealing in Evergrande securities or likely to deal in them, Mr. Lung was of the view that, having regard to the "relatively large market capitalization and turnover of Evergrande", investors

were likely to include institutions and retail investors, a substantial number being relatively sophisticated investors.

152. On the morning of 21 June 2012, Mr. Karl Lung accepted that "mom and pop investors sitting at home" would have been very unlikely to have learned of the Citron Report. However, as he put it, with the news breaking in the early hours of trading, there would have been analysts in the broking houses with a "US background" who would have known about the reputation of Citron Research and would have alerted others that the Report had been issued. It was his evidence that it was not a report that could be ignored. Originating in the United States at that time, initially at least, it would have been accorded some credibility, more especially as at that time there was a perception that research reports originating in the United States tended to be of a better quality and more reliable due to perceived tighter regulations.

153. In any event, he said, this was not some essentially mundane commentary limited to the expression of concern at Evergrande's high leverage. This report made far graver allegations. As he put it: "… if what this Report says is correct – or even half correct – the consequence… could be very serious."

154. The Tribunal accepts the force of these matters. The Tribunal also takes into account that the Citron Report was not a document that could simply be ignored. First, Citron Research itself had an easily ascertainable reputation, indeed a somewhat unnerving reputation. Second, as mentioned earlier, it was a substantial document filled with data, graphs, lists and the like. Third, the

allegations made were direct and combative, making assertions that were of the utmost seriousness. Whether, on more careful analysis, it proved to have no substance, it must on any initial reading have been a disturbing document and one quite capable – even if over a limited period of time – of having an impact on the market.

155. During the course of his testimony, Mr. Lung was asked why relatively sophisticated investors would chose to ignore the broad body of opinion that had been supporting Evergrande as a 'buy' and follow the Citron Report. Mr. Lung replied that common sense psychology had to be taken into account. As he expressed it, if you are holding shares in a listed company and there is a report circulating – one that cannot outright be ignored – saying that the company will almost inevitably collapse then there is a greater urge to sell rather than run the risk of a substantial loss.

156. No doubt too, as Mr. Lung noted, there may have been people in the market wishing to take tactical advantage of such disturbing news: short sellers, for example, who may be content to see the news circulating. As the Tribunal itself notes, all large, sophisticated markets have such persons and their ability to seize on such news must be accepted in calculating a likelihood of impact.

157. The Tribunal accepts that stock markets are not always driven by careful and leisurely analysis carried out by experts, that markets may well react to portents of grave times ahead, even if those portents are somewhat suspect. Put in everyday language, better be safe than sorry. It has not been unheard of for investors (and their brokers) to divest themselves of securities on this basis.

158. Certainly, Evergrande itself, even though it dismissed the Citron Report as being of no substance, did not take the view that it could ignore it, feeling compelled on 22 June 2012 – a day later – to issue a long and detailed document refuting the many allegations that had been made against it.

159. In all the circumstances, the Tribunal has had no difficulty in coming to the determination that the Citron Report, when posted on the Internet on the morning of 21 June 2012 (Hong Kong time), was likely within a very short period of time, that is, within a matter of hours, to have an impact, indeed a material impact, on trading in Evergrande shares on the Hong Kong market.

160. What then did happen that day? Earlier in this report, mention has been made of Mr. Karl Lung's analysis of trading in Evergrande shares on 21 June 2012. In summary, he found that –

(i) During the course of that morning, he said, the share price fell from a high of $4.52 to a day low of $3.60, down 19.6% from the previous day's close of $4.48. Despite the fact that the senior management of Evergrande conducted a tele-conference with analysts and made an announcement through the Stock Exchange, the share still closed at $3.97, this being down 11.4% on the previous day. As a reference, the Hang Seng index declined 1.3% that day.

(ii) Trading volume, he said, reached 940 million shares that day. The highest daily trading volume earlier that year had been just 232 million shares.

(iii) Volatility, he said, reached 22.7%, the highest daily volatility earlier that year being just 12%.

161. On the basis of his assessment of relevant evidence, Mr. Karl Lung was of the opinion that it was clear that the Citron Report placed significant selling pressure on Evergrande shares that day, materially increased trading volume and was responsible for a significant increase in the volatility of the share price.

162. The Tribunal is aware of the danger of employing hindsight to determine a predictive test, a test that does not look to what did happen but instead looks to earlier in the chronology of events as to what was likely to happen. That is why in the present case it has reached its determination without reference to what in fact did happen on 21 June 2012. Nevertheless, some limited support for the Tribunal's findings can be found in the fact that the likely impact was born out by the actual impact.

CHAPTER 5

THE THIRD REQUISITE ELEMENT OF S.277(1)

The element of falsity, namely, the requirement that the information must be false or misleading as to a material fact

163. As indicated earlier, the SFC sought to demonstrate that the Citron Report was false and/or misleading as to a material fact by focusing on two subject areas –

(i) that part of the Citron Report which asserted that in its public financial statements Evergrande had been culpable of 'fraudulent accounting'; that is, of presenting fraudulent information to the investing public; and

(ii) that part of the Citron Report which stated that in reality Evergrande was insolvent.

How was the Citron Report to be read?

164. As earlier indicated, the Citron Report sought impact by the use of direct, plain, Tabloid language. Issues were not approached obliquely nor were they obviously couched as opinions to be weighed in the scales of all the evidence. As to Evergrande's financial position, the Citron Report said – under the heading of "Reality" (that is, the true picture) – that its analysis and primary

research indicated that the Company was “insolvent”.

165. How had that reality been previously concealed? The Citron Report put that down to what, on any ordinary reading, was a course of dishonest conduct by Evergrande. The Citron Report described important aspects of the Company’s published financial statements as constituting “fraudulent accounting” employed to “mask” Evergrande’s insolvency.

166. These assertions were to be digested in the context of other blunt language, for example, that Evergrande had paid “bribes” to local government officials on the Mainland in order to “illegally” build Evergrande’s land inventory.

167. While obviously the words employed in the Citron Report were not intended to be read in a narrow legal sense, their everyday meaning remains telling. To state that the reality is that a company is ‘insolvent’ is to say, in everyday language, that it is unable to pay its debts; put another way, that it is under grave financial stress. Such a statement goes to the inherent viability of the company. To state that a company has employed “fraudulent accounting” to mask its financial woes is to say, on any ordinary reading, that, in the presentation of its financial position, it has dishonestly sought to deceive the market as to its true financial position.

168. On behalf of Mr. Left, it was submitted by Mr. Li that the words and phrases, read in context, were not to be given their strict literal meaning. This was not, he said, how the words were intended to be read. What Mr. Left and

his team were intending to say was that, by playing with accounting treatment, Evergrande had sought to avoid revealing its true financial state. In this regard, Mr. Li referred to an article in the Wall Street Journal which, he submitted, reflected how those in the market would have understood matters:

> "Short-seller Citron Research released a report last Thursday accusing the real estate developer [Evergrande] of *using accounting tricks* and bribes to hide its insolvency." [emphasis added]

169. In response, Mr. Duncan, for the SFC, submitted that, as Mr. Left had chosen not to give evidence, there was no evidential basis for exactly how he wanted his words to be understood. It was simply not sustainable, said Mr. Duncan, to suggest that words such as 'insolvent' and 'fraudulent' should on examination be watered down to encompassing actions by Evergrande that had been little more than 'questionable'.

170. In the judgment of the Tribunal, the evidence points clearly to the fact that Mr. Left and his research team – it being remembered that they had published similar reports and been involved in earlier litigation – used their words advisedly. They knew the meaning they intended to convey. They knew the impact they wished to achieve.

171. To illustrate by way of contrast: to say that a company has 'taken advantage of complex and often lax accountancy standards to seek to obscure its growing financial difficulties' is markedly different from saying that a company has resorted to 'fraudulent accounting' in order to 'mask its insolvent balance

sheet'. The first suggests perhaps 'sharp' use of existing accountancy standards, legal but questionable. The second suggests clearly a deeper and more odious culpability, the employment of fraud, that is, intentionally dishonest conduct.

172. Mr. Left (and his team) chose the second form of words. It was an informed decision – for whatever motive – and the wording of the Citron Report must accordingly be judged on its plain meaning.

The testimony of Mr. Yeung Chor Ho

173. Between 2009 and 2012, Mr. Yeung had been the partner of PricewaterhouseCoopers – a firm of international standing – responsible for auditing the accounts of Evergrande. He testified that Evergrande's 2011 and 2012 financial statements (the latter being post the Citron Report) had been prepared in accordance with the applicable Hong Kong Financial Reporting Standards and he was satisfied that they complied with those standards.

174. Mr. Yeung further testified that during the audit of Evergrande's 2011 and 2012 financial statements neither he nor his auditing team had come across evidence to suggest –

(i) that Evergrande was unable to pay its debts when they fell due;

(ii) that the liabilities of Evergrande exceeded the value of its assets; or

(iii) that Evergrande had engaged in any fraudulent accounting as alleged in the Citron Report.

175. Mr. Yeung confirmed that, when preparing the 2012 financial statements for Evergrande, he and his auditing team had given consideration to the various allegations that had been made in the Citron Report. However, they had found nothing in the Citron Report that required them to adopt a different approach to the approach that had been adopted in 2011. Nor, in light of the Citron Report, did they find it necessary to undertake any further investigative work.

176. Put in layman's terms, although Mr. Yeung and his team, as auditors, had no general mandate to act as forensic investigators seeking out indicators of insolvency and/or fraud, they were nevertheless unable to ignore indications of it. In the present instance, they had been obliged therefore to give consideration to the various allegations made in the Citron Report but clearly had found nothing in them to require investigative work or a change in the accounting methodologies adopted in respect of the 2011 financial statements. In short, viewed through the prism of professional accountants carrying out the role of auditors, the allegations contained in the Citron Report caused them no concern.

177. The evidence of Mr. Yeung – given in an objective, professional and restrained manner – was important in that it supported other evidence advanced, especially that of Mr. Phenix, the expert in accountancy matters called by the SFC, that the allegations of "insolvency" or being "essentially insolvent" and

"fraudulent accounting" contained in the Citron Report displayed an ignorance of Hong Kong accountancy standards and practices. In addition, more indirectly, it supported the evidence advanced on behalf of the SFC that no evidence of fraud had been revealed. The Tribunal was satisfied that it could place reliance on Mr. Yeung's evidence.

178. Mr. Yeung further testified that he had played a role in the publication of the two clarifications announcements published by Evergrande in answer to the Citron Report[19]. In this regard, he was able to confirm that the details of accounting treatment set out in the Second Clarification Announcement (published on 22 June 2102) were consistent with the approach adopted in the 2011 financial statements. In short, Evergrande had not found it necessary to shift its stance in order to answer the Citron Report allegations: the answers given in the Second Clarification Announcement, therefore, had explained what had already been set out in the 2011 financial statements[20].

The testimony of Mr. Tse Wai Wah, Parry

179. From joining Evergrande in 2009, Mr. Tse had held the position of Chief Financial Officer. He was one of the directors of Evergrande who had approved the two clarification announcements issued in answer to the Citron Report. In his testimony Mr. Tse confirmed the accuracy of the detailed answers given in the Second Clarification Announcement.

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[19] In order to fulfill this role, said Mr. Yeung, he had had to confirm limited financial data held by the auditing team and not therefore in the public domain. As the Tribunal understood it, however, that exercise had been purely for the purpose of confirming the accuracy of what was in the public domain and did not, therefore, invalidate his evidence in advancing the enquiry.

[20] In this regard, see the endorsement in bold lettering on page 5 of the Second Clarification Announcement.

180. Mr. Tse also confirmed that, on all the evidence available to him in or about June 2012, Evergrande had been in a position to pay its debts as and when they fell due and the value of the Company's assets had exceeded the value of its liabilities. Evergrande was not therefore insolvent when the Citron Report was published.

181. In the headline describing Evergrande's "fraudulent account schemes", it was alleged in the Citron Report that Citron Research was not the only "analysts" who had identified "fraud" at the Company. In October 2011, an announcement had been made by the PRC Ministry of Finance that it would be fining Evergrande for reporting inaccurate financial statements. Mr. Tse testified that there had been no fraud. Rather – as reported in paragraph 7 of the Second Clarification Announcement – there had been a failure by a major subsidiary, the Guangzhou Evergrande Real Estate Group Company, which itself had some 50 subsidiaries, to prepare consolidated accounts when it prepared its PRC statutory accounts for the year ended 31 December 2009, only the stand-alone accounts being prepared.

The testimony of Mr. Paul Phenix

182. Mr. Phenix was called by the SFC to give evidence as an expert witness in matters of accountancy.[21]

[21] Among his other academic and professional qualifications, and professional and commercial experience, Mr. Phenix, a Fellow of the Institute of Chartered Accountants (England and Wales) and a Fellow of the Hong Kong Institute of Certified Public Accountants, has a Master of Business Administration degree. He has served as Technical Director of the Hong Kong Society of Accountants, has wide teaching experience and serves as a member of the Stock Exchange of Hong Kong Listing Committee.

183. It should be said that the Tribunal found Mr. Phenix to be an impressive witness, well versed in the complexities of Hong Kong accountancy standards, firm and clear in his views. It had no difficulty accepting the strength of his evidence.

184. By way of an overall view of the Citron Report, it was Mr. Phenix's evidence that, having conducted an in-depth analysis, he had been drawn (in particular) to the following conclusion, namely, that the general tone and the particular content of the Citron Report would in all likelihood be seen as "unreasonable, incorrect or fanciful" by a professional analyst or a professional property analyst[22]. The same, however, could not be said of general investors.

185. In analyzing the Citron Report, Mr. Phenix was of the opinion that the multiple allegations contained in that report relating to Evergrande's "insolvency" and its employment of "fraudulent accounting" in order to disguise its true level of debt were in many respects confused and contradictory. Mr. Phenix was also firm in his view that the allegations revealed a fundamental ignorance of the Hong Kong Financial Reporting Standards. In this regard, it was his opinion that, when viewed through the prism of contemporary accounting and auditing standards applicable in Hong Kong, many of the allegations made were so misguided as to be "nonsense".

[22] In the Tribunal's view, this would go a long way to accounting for the almost immediate and almost universal repudiation of the Citron Report by professional analysts with knowledge of the Mainland real estate sector and the requirements of Evergrande to comply with Hong Kong accountancy standards.

186. It would be appropriate at this juncture to record the fact that, by way of a general overview, having considered all the evidence put before it, the Tribunal was itself of the view that the author/authors of the Citron Report had displayed a low level of understanding of contemporary Hong Kong financial accounting standards and of financial reporting in this jurisdiction. This does not mean of course that the allegations made in the Citron Report were, by that fact, false and/or misleading. But that said, the Tribunal is of the view that to make the kind of bold allegations that were contained in the Citron Report without being fully informed as to relevant accountancy standards and practices must greatly heighten the risk of those allegations being materially misguided.

187. Having regard to what he considered to be the often confused and contradictory nature of the many allegations contained in the Citron Report, Mr. Phenix attempted to give them some structure by identifying each of them and, where possible, placing them into appropriate groups or clusters, more especially the allegations that related to technical accountancy issues. Mr. Phenix therefore prepared (as part of his expert report) a summary of the allegations made in the Citron Report – he listed a total of 33 such allegations – with a summary of his observations in respect of them. For ease of reference, the Tribunal will refer to this as the 'Issue Summary'. In giving his testimony, Mr. Phenix adopted the contents of his expert report including his Issue Summary.

A. The insolvency allegation

188. As to the allegation that Evergrande was "insolvent" – an existential allegation – Mr. Phenix commented in his Issue Summary that the allegation was not, judged on the available evidence, a reasonable one to make. Evergrande, he said, was not, in his opinion, "remarkably or comparatively illiquid".

189. As to the allegation that Evergrande had "generated cumulative operating cash flow before Capex of negative RMB 28 billion since 2006", its growth strategy relying heavily on ever-increasing access to debt financing, Mr. Phenix made the following observations: first, that Evergrande did have a thin operating cash flow but this was normal in the Mainland property development industry; second, the assertion of Evergrande having a negative operating cash flow was based on a restating of the Company's figures, that restatement being based on invalid allegations; third, that relying on debt financing in the Mainland property development industry was not unusual and, fourth, that, although Evergrande's debt load had increased it still appeared (as at 31 December 2011) to be within industry norms.

190. As to the collateral allegation that Evergrande, in reporting RMB 35 billion of equity as at 31 December 2011, was either overstating assets or understating liabilities and that, adjusting for these misstatements, Evergrande was "negative RMB 36 billion", Mr. Phenix commented that this restating of Evergrande's figures was based on invalid allegations contained in the Citron Report, allegations that, with any understanding of Hong Kong accountancy

standards were not reasonable.

B. The first cluster of technical accountancy allegations – the use of "off balance sheet" vehicles in order to underreport debt

191. As Mr. Phenix expressed it, this first cluster of allegations was focused on Evergrande's supposed use of various kinds of 'joint venture' deals that enabled it to exploit "off balance sheet" financing as a standard business practice and thereby to underreport large amounts of debt.

192. In this regard, the Tribunal notes that employment of "off balance sheet" vehicles was described in the Citron Report not simply as a form of financial reporting that, although legal, was nevertheless unacceptable in that it disguised material amounts of Evergrande's debt, it was, to the contrary, described in direct terms as "fraudulent accounting". This is illustrated by the headings on pages 15, 16 and 17 of the Citron Report –

a) "Page 15 – Fraudulent accounting: Evergrande's use of off-balance sheet vehicles is as astounding. Evergrande uses JV equity partners to finance individual projects. The JV partnerships are structured with mandatory buyback guarantees. Therefore, Evergrande's equity JV partners are lenders in reality. The JV scheme allows Evergrande to grossly underreport its debt. At large IRR to the off-balance sheet investors (*sic*), these partnerships are quite similar to the ones that Enron infamously employed."

b) "Page 16 – Fraudulent accounting: Evergrande exploits off-balance sheet financing as a standard business practice. During 2010, Evergrande disclosed RMB 3.9 billion in guarantees related to consolidated JV deals, RMB 1.7 billion of guarantees related to unconsolidated JV deals and an additional RMB 11.7 billion in commitments for unpaid land expenditure. In early 2010, we estimate that Evergrande underreported its debt related to various JV deals equal to RMB 17 billion."

c) "Page 17 – Fraudulent accounting: today, Evergrande's off-balance sheet debt related to JV buybacks and unpaid land deals exceeds RMB 23 billion and possibly as much as RMB 56 billion. Evergrande's off-balance sheet shenanigans continues. Evergrande no longer discloses guarantee associates with JV buyback guarantees. A review of Evergrande's 2011 annual report reveals that Evergrande is hiding at least RMB 23 billion in off-balance sheet debt: reported minority interests were RMB 1.8 billion and unpaid land expenditures were RMB 21 billion at 31 December 2011."

193. In his Issue Summary, Mr. Phenix commented that –

(i) There were no "off balance sheet" vehicles such as "JV equity partners". The counterparties to the transactions are identified in the independent accountants' report and the relevant financial statements as lenders that provide finance for the acquisition of interests in companies with land use rights in the Mainland.

(ii) These lenders are not joint venture partners nor is there any joint control under Hong Kong Accountancy Standard 31.

(iii) There are no mandatory buy-back guarantees. What is described in the Citron Report are simply "collateral/default" terms contained in loans granted for the acquisition of companies with land use rights which remain incomplete because the terms of the sales and purchase agreements have not yet been fulfilled.

(iv) Ironically, the conclusion reached in the Citron Report that the "equity JV partners" are in fact lenders is therefore correct.

(v) On all available evidence, Evergrande has complied with the relevant Hong Kong Financial Reporting Standards, [HKAS 31, HKAS 27 and HKFRS 3], an opinion supported in the audit opinion.

(vi) The allegations made in the Citron Report show a "fundamental ignorance of the Hong Kong Financial Reporting Standards".

194. It was the thrust of the evidence given by Mr. Phenix that what was asserted – wrongly – in the Citron Report was in truth a form of financing for the acquisition and development of land in the Mainland that, although perhaps unique to the Mainland and not well understood elsewhere, was well understood by those who worked in the Mainland property sector and those who regularly

commented on that sector. More importantly, far from being a form of fraud, it was a form of financing recognized and permitted by the applicable accountancy standards.

195. Mr. Phenix gave an explanation of how the financing worked in respect of the acquisition and development of land in the Mainland. In the broadest terms, the Tribunal understood the position to be as follows:

(i) In the Mainland, parcels of land would be disposed of by local authorities, often to locals, and such acquisitions would then be placed into corporations, not unlike elsewhere in the world. In the Mainland, it was difficult simply to buy and sell land.

(ii) A company such as Evergrande, in acquiring a land bank, would purchase the shares in a land-holding corporation. In short, a form of sale and purchase agreement – not any form of joint venture agreement – would be entered into.

(iii) However, there would still be formalities to fulfill (bureaucratic red tape) which may take an extended period of time to be resolved, many months or even years.

(iv) In light of this, a company such as Evergrande, while invariably paying in cash, would not pay the full amount immediately but would pay a deposit pending final resolution of all formalities. The deposit would either secure 51% of the shares – a practice

followed by Evergrande – which would give a company such as Evergrande immediate control, the acquired corporation becoming a subsidiary, or the deposit would secure a lesser share interest which would mean that the acquired corporation would not become a subsidiary and would be accounted for in the consolidated balance sheet as a property development asset giving land use rights.

(v) In order to obtain finance to pay for the acquisition of a land bank in the manner described, a company such as Evergrande would borrow money, some of the borrowings being from the formal banking sector and some, because of the difficulty of obtaining loans to purchase land from the formal banking sector, would be obtained from trust companies, sometimes called ‘shadow banks’.

(vi) Such borrowings would obviously be subject to interest (invariably at higher rates than those charged in the formal banking sector) and would be secured by the shares that a company such as Evergrande had obtained in the payment of its deposit to a land-owning corporation.

(vii) The potential profit in such borrowings would then be resold by the bank or trust company as a retail investment product.

196. As to the reflection of this form of financing in the consolidated financial statements of Evergrande, Mr. Phenix said that, at about the time of the publication of the Citron Report, the Hong Kong Financial Reporting Standards and the Hong Kong Generally Accepted Accounting Principles did not require identification of the lenders to enable the identification of the source of loans and therefore, for example, whether they were trust loans. However, both forms of loans were recorded as 'borrowings' in the consolidated balance sheet. Mr. Phenix said that, after a study of all relevant papers, in the absence of any contrary evidence, he believed it was "entirely reasonable to interpret borrowings in the relevant documents as being solely borrowings from unrelated financial institutions, whether as trust loans or as loans from formal banks".

197. Mr. Tse, Evergrande's Chief Financial Officer, drew attention to, and adopted, the reply contained in Evergrande's Second Clarification Announcement which (in section 1) made it clear that, in respect of trust financing, these had always been classified as liabilities and not as some interest in a joint venture arrangement.[23]

198. In his testimony, Mr. Tse also made reference to the note contained in the Company's 2011 Consolidated Financial Statements under the heading of 'Other borrowings'. This, he said, was evidence that the Company's trust financing arrangements had not been 'hidden' but had been disclosed in accordance with prevalent accountancy practice –

[23] The relevant answer in the Second Clarification Announcement read: "With respect to trust financing, the Group has always classified trust financing as liabilities [i.e. money owed] and has not accounted such amount as minority interest [in some form of joint venture arrangement]. Therefore, the minority interest of RMB2.2 billion reflected in the financial statement of the Company as at 31 December 2011 did not involve any repurchase arrangement."

> "During the current year, certain group companies in the PRC which are engaged in development of real estate projects have entered into fund arrangements with certain financial institutions ('the Trustees'), respectively, pursuant to which Trustees raised trust funds and injected the funds into the group companies. All the funds bear fixed interest rates, have fixed repayment terms, and are secured by the properties under development of the group companies or the shares of certain group companies."[24]

199. As to the allegation contained in the Citron Report that Evergrande had exploited off balance sheet financing by – in part – disclosing RMB 11.7 billion "in commitments for unpaid land expenditures", Mr. Phenix commented (in his Issue Summary) that these must refer to items disclosed in the 2010 and 2011 audited consolidated financial statements as commitments "contracted but not provided for". Assuming that this classification was appropriate, he said – i.e. that the amounts are not required to be recorded as liabilities or debt under the Hong Kong Financial Reporting Standards – then the

[24] The note then set out the following figures –

> "The net assets of these shares as at 31 December 2011 were approximately RMB7,507,026,000 (31 December 2010: nil).
>
> As at 31 December 2011, the Group's bank and other borrowings of RMB34,294,602,000 (2010: RMB22,409,880,000) were secured by its investment properties, property and equipment, properties under development, completed properties held for sale and cash in bank.
>
> The exposure of the borrowings excluding senior notes to interest-rate changes and the contractual repricing dates or maturity date whichever is earlier are as follows [in RMB'000]:

	6 months or less	6-12 months	1-5 years	total
Group				
At 31 December 2011	19,493,133	7,170,632	7,630,837	34,294,602
At 31 December 2010	12,577,280	8,040,510	1,792,090	22,409,880"

disclosure complies with the relevant accountancy standards.[25]

200. The Tribunal is satisfied that, although to a number of observers, trust financing on the Mainland remained opaque – a matter which will be considered shortly – Mr. Phenix was correct in his analysis of its true nature.

201. As to the fact that trust financing was an emerging system on the Mainland, Ms. Eva Lee Chi Wing, an executive director at UBS, head of Hong Kong and China Property Research, testified that she was aware that companies in the property sector in the Mainland engaged fairly extensively in such financing and that Evergrande did not stand alone in this regard. In or about 2011, she said, in light of bank restrictions, trust financing had become popular, enabling insurance companies and the like to invest in high-yield investments. Developers seeking a bigger land bank, she said, unable to obtain financing from the formal sector or via the bond market, regularly opted for trust financing.

202. As to the existence of 'off balance sheet debt' (exceeding RMB 23 billion and possibly as much as RMB 56 billion: as asserted on page 17 of the Citron Report) on the afternoon of 21 June 2012, after a tele-conference with senior management of Evergrande, Ms. Eva Lee put together an analysis of Evergrande which was published that same day. In the analysis, a 'buy' recommendation was still made and, in answer to the allegations related to such high 'off balance sheet' debt, the analysis informed its readers that there was 'nil off-balance sheet debt'. The comment read –

[25] In particular Hong Kong Accountancy Standards 1 and 32.

> "Management reiterated that they have no off-balance sheet debt and all liabilities are reflected in the balance sheet. Parry Tse, CFO of Evergrande, reassured us all of its projects are held at stakes of 51% and above, therefore, off-balance-sheet liabilities will not be arisen. In addition, management indicated the high yield debt covenant required all its projects have to be held at 51% ownership and above."

203. As to Evergrande's trust financing debt, the UBS analysis said that, as it understood the position, trust financing amounted to RMB 1 billion, representing just 14% of its total borrowings.[26]

204. In his expert report, Mr. Phenix said that, although the allegations in the Citron Report were imprecise and confused, it could only be that Evergrande's so-called "joint venture" partners were either the land-holding corporations being acquired or the banks or trust companies which had provided the finance. In either case, he said, the allegations contained in the Citron Report were incorrect[27] and were likely to mislead any reader to except a professional analyst or professional property analyst.

205. Of course, the SFC case was not limited to the narrow confines of whether technically the Citron Report had identified correctly off balance sheet vehicles such as joint ventures. The SFC case was founded on the basis that, in

[26] During the course of his evidence, Mr. Phenix commented that, even though the Central Government of the PRC does not like trust loans, they are not illegal. He commented that in many companies the level of trust loans was high but in fact that was not the case with Evergrande at the relevant time.

[27] In coming to this conclusion, Mr. Phenix conducted a detailed analysis of the Hong Kong Accountancy Standards as they relate to joint ventures showing that, in accordance with such standards, it would not have been possible to record the process by which Evergrande acquired its land bank and financed it as any form of 'joint venture' process.

fundamentally misunderstanding the manner in which Evergrande had acquired its land bank and financed it, the Citron Report had been drawn into making allegations against the Company of the most serious kind, namely, that of a course of conduct amounting to fraudulent accounting.

206. Mr. Phenix accepted that fraud may be concealed behind the sometimes opaque nature of financial statements. He did not simply, therefore, look to whether Evergrande's consolidated financial statements complied with relevant accountancy and auditing standards. He attempted to go beneath the skin, he said, to see whether, deeper down, there was any merit in the allegations of fraudulent accounting. He was satisfied, however, that there was no merit in such allegations. As he expressed it:

> "When I started looking at this… I thought he [Mr. Left] must have some information that there is a fraud here. I didn't automatically assume that the financial statements, the audited financial statements and the independent accountants report, were legitimate. I was looking to see if there was any evidence of… fraud. I came to the conclusion… that in fact, on the basis of the available evidence [in June 2012], there was no evidence anywhere of a fraud. If you make allegations of fraud, I think you would have to back them up with some kind of evidence. The evidence he produced is just nonsense."

207. Mr. Phenix was firm in his evidence that there was no merit in the allegations of fraudulent accounting made by Citron Research in the first cluster of allegations. Indeed, he felt it appropriate to say that the joint venture

allegations to an accountant were “fanciful”.

208. It may be that certain investors viewed the allegations in the Citron Report with a degree of scepticism. Mr. Phenix himself accepted that “professional analysts or professional property analysts” would no doubt have understood very quickly that the allegations were misconceived. The Tribunal is satisfied, however, that general investors would have found the allegations to be unnerving at best. For readers, two toxic elements – reprehensible, underhand conduct and billions of dollars of hidden debt – were alleged in the bluntest of terms. The so-called joint venture vehicles were compared to vehicles that had apparently been employed by Enron, a major United States company and the subject of one of the largest and most complex liquidations in recent history.

209. It is also to be remembered that Citron Research was not a known quantity in Hong Kong; it was not therefore a case of readers digesting what was said on the basis that this was how Citron Research always composed its analyses. Nor were the allegations unsupported. The allegations headlined what appeared to be an in-depth analysis.

210. On behalf of Mr. Left, Mr. Li submitted that at the relevant time trust financing remained so opaque, so subject to organic growth, that it was not only understandable that Mr. Left should have come to the conclusions that he did, there was evidence that he was not alone in doing so. Mr. Li found some support for this in an article published by a Mainland financial magazine (‘the Mainland financial article’) which, in commenting on the Citron Report, itself

conducted a lengthy examination of the trust loan business in the Mainland. In translation, the article appears to have been headed in incomprehensible language: "Risk exposure of false equity real debt trust scheme". One of the subjects of the article was a trust loan arrangement entered into in terms of which Evergrande acquired a corporation called Hunan Xiongzhen Investment Co ('HZI'), that same arrangement being referred to in some detail in the Citron Report itself.

211. In his analysis of that arrangement, Mr. Phenix said that it was evident that, in terms of the arrangement, Evergrande was to acquire a 51% interest in HZI, it being agreed that the remaining 49% would be purchased when certain conditions had been fulfilled. Those conditions related primarily to successful approvals being received from the relevant local authority as to the transfer of land use rights. It was common for such a process to be very extended, said Mr. Phenix, sometimes stretching to many years. On the evidence, Evergrande was to finance the acquisition of the remaining 49% minority shareholding by way of a 'trust loan' from a trust company. In light of this, Mr. Phenix wrote in his expert report:

> "Assuming that this description of the terms of the trust loan in the Citron [Report] is correct, it is clear even from the Citron Report itself that the arrangement was *simply a loan* which was secured on [Evergrande's] existing 51% ownership of HZI. There is no JV relationship with the vendors or the trusts under [the Hong Kong accountancy standards] and none could be inferred from a reasonable reading [of relevant documents]."

212. It became clear to the Tribunal during the course of the enquiry that, as Ms. Eva Lee had commented when she testified, a business had built-up around 'trust financing' in the Mainland. The Tribunal recognizes that this may have provided fertile soil for the creation of investment products and no doubt many were complex in nature. No doubt too, to those not experts in the field, this proliferation may have been some cause for confusion. In the Mainland financial article it was said (in translation) that:

> "A source from the trust industry told reporters there are currently three main categories of real estate trust products: development loans, mezzanine financing and equity investment, and equity investment is further divided into 'false equity real debt' and 'real equity'."

213. On behalf of Mr. Left it was argued that he did not hold himself out to be an expert in the field and in all the circumstances, looking to what was indicated (or *not* indicated) in the material available to him, it was not unreasonable for him to be drawn to the conclusion that Evergrande had accumulated large amounts of off balance sheet debt.

214. In the SFC's response, it was argued that, if the Citron Report was to make such damning assertions concerning Evergrande's financial reports, it had an obligation at least to ensure it understood the true nature of trust financing and its application to Evergrande. This, it was submitted, could best be done by two simple, common sense approaches being adopted. First, by approaching Evergrande itself for clarification (an approach apparently often adopted by professional analysts) or by seeking the advice of experts. Neither was done. On behalf of Mr. Left, Mr. Li challenged this, saying that it was

debatable that Mr. Left should be held to the standard of an expert familiar with Hong Kong accounting rules as well as accounting practices of mainland real estate developers. The Tribunal does not agree. First, for all practical purposes Citron Research had held itself out as being an expert body, stating in its website that with over 150 reports it had amassed a track record identifying fraud and terminal business models and in this regard was second to none among published sources. This was said quite clearly to give credibility to its reports including the report published in respect of Evergrande. Second, if it chose to make such severe allegations concerning technical issues of accounting applicable in Hong Kong, allegations that it must have appreciated could have material financial consequences, it surely had an obligation to fully understand such issues.

215. On behalf of Mr. Left, it was argued that he should not be held to the standard of an expert, a person familiar with Hong Kong accountancy standards. Mr. Left, it was said, had never held himself out as such. The Tribunal will consider this issue more fully later. At this juncture, however, it suffices to observe that, while Mr. Left and his research team may not have held themselves out in specific terms to be experts in Hong Kong accountancy matters, on any ordinary and reasonable reading, they did hold themselves out to be experts in the area of identifying corporate fraud. Not experts necessarily by way of formal qualification but certainly by way of experience. Citron Research promoted itself by saying that with over 150 reports it had amassed a track record of identifying fraud and terminal business models and in this regard was second to none among published sources. The Citron Report was therefore promoted as the work of a professional body.

216. The Tribunal is satisfied that it was no defence for Mr. Left to equivocate over the expertise of his research team. The Tribunal is satisfied that, for an organization like Citron Research – that held itself out as a crusader against corporate fraud – it had a responsibility to fully understand the nature of trust financing before making such bold allegations against Evergrande. Indeed, in this regard it can be said that the more complex the issue the greater the difficulty on the part of ordinary investors to reject the allegations of "fraudulent accounting" used to mask Evergrande's state of "insolvency" that were made in the Citron Report.

217. The Tribunal has accepted that perhaps certain aspects of the financial reporting standards in respect of trust financing were open to legitimate criticism. Opinions that are critical, however, are to be contrasted with direct accusations going to matters of fact; in the present case that Evergrande had been culpable of "fraudulent accounting", its dishonest intent being to mask its true financial state, namely, its state of "insolvency".

218. On all the evidence, the Tribunal is therefore satisfied that, in respect of the first cluster of allegations (as categorized by Mr. Phenix), the allegations of "fraudulent accounting" and "insolvency" not only displayed an ignorance of, or disregard for, the prevailing Hong Kong accountancy standards, they were both fundamentally misguided. Put in plain language, the Tribunal is satisfied that such allegations were false. Failing that, they were clearly misleading. In both respects, they were false and/or misleading as to material facts.

C. The second cluster – overstating the value of Evergrande's property investment portfolio, creating "phantom" profits and underreporting development costs

219. Evergrande is a property holding and property developing company. The integrity of the manner in which it values its investment property portfolio is therefore fundamentally important to an accurate understanding of the Company's value.

220. Evergrande has defined its investment properties as properties "held for long-term rental yields or for capital appreciation or both, and that is not occupied by the Group. Property that is currently being constructed or developed for future use as investment property is classified as investment property."

221. The Citron Report alleged that Evergrande had been culpable of "fraudulent accounting" by overstating the value of its investment property portfolio by at least RMB 10 billion. The Citron Report further alleged that, despite low yielding, the investment property portfolio had been so significantly built up since 2006 that "phantom" accounting profits of RMB 9.5 billion had been created.

222. Clearly, what lay at the core of the Citron Report allegations was the methodology employed by Evergrande to value its very considerable number of investment properties of different types held in numerous locations in the Mainland.

223. As to the appropriate methodology, in its 2011 consolidated financial statements, Evergrande described its accounting policies in respect of its investment properties in the following terms:

> "Investment property is measured initially at its cost, including related transaction costs.
>
> After initial recognition, investment property is carried at fair value. Where fair value of investment property under construction is not reliably measurable, the property is measured at cost until the earlier of the date construction is completed or the date at which fair value becomes reliably measurable. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific asset. *If this information is not available, the Group uses alternative valuation methods such as recent prices on less active markets or discounted cash flow projections*.[28] " [emphasis added]

224. In the face of this, Citron Research calculated that, as Evergrande earned less than one percent gross yield on its investment property portfolio, this suggested that its marked to market – fair value – valuation of the portfolio was "wildly overstated". The portfolio had been marked up so significantly since

[28] As Mr. Phenix explained in the course of his testimony, there are therefore three major valuation bases employed by Evergrande (and permitted by the relevant Hong Kong accountancy standards); principally 'fair value', that is, 'marked to market' and two sub-bases: one of the two sub-bases being what is described as a discounted cash flow – DCF – projection. As the Tribunal understands it (by way of a broad description only), this form of analysis seeks to examine projected future income or cash flow and to discount it in order to arrive at an estimated current value. Determining the discount rate involves a number of variables that may be difficult to accurately predict.

2006, it was said, that "phantom" accounting profits of RMB 9.5 billion had been created on the Company's income statement and the same amount by way of a "phantom" book value. This process, it was said, was another example of Evergrand's "fraudulent accounting".

225. The Citron Report allegations are summarized by the headings on pages 21, 22 and 23 –

a) "Page 21 – Fraudulent accounting: Evergrande's investment property portfolio is overstated by at least RMB 10bn, equal to one-third of its book value. We triangulate on the amount of overstatement of Evergrande's investment portfolio by using two separate methods:1] market valuation method (outlined on page 21) and 2] balance sheet method (outlined on page 22 and 23). Both methods support that Evergrande's investment property portfolio requires at least a RMB 10bn write-down.

Evergrande earns less than <1.0% gross rental yield on its investment portfolio, which suggests that Evergrande's "market" appraisal of its investment property is wildly overstated. Assuming a 2% gross rental yield would imply that Evergrande's investment property is worth 4.2bn, 71% less than its stated value. In other words, Evergrande's investment portfolio properties are overstated by at least RMB 10bn."

b) "Page 22 – Fraudulent accounting: Despite low yielding, the investment property has been marked up significantly since 2006, creating

RMB 9.5bn phantom accounting profits on its income statement and RMB 9.5bn phantom book value.

To date, Evergrande has recorded RMB 9.5bn of mark-to-market on its investment property, representing 29% of Evergrande's reported shareholders' equity as of December 31, 2011. Evergrande simply says that it had an appraiser using a combination of valuation methods to determine the value of the portfolio and no specific details are disclosed regarding how these gains were achieved.

c) "Page 23 – Fraudulent accounting: Our analysis also reveals that Evergrande underreported its development cost of RMB 4bn by capitalizing costs onto its balance sheet as investment property.

Our analysis indicates that Evergrande is understating the development costs for its property business by capitalizing costs onto its balance sheet as investment property. We estimate that Evergrande's investment properties have a balance sheet cost basis of RMB 7,335 per square meter. In contrast, we estimate that Evergrande's development cost for non-investment property is RMB 4,260 per square meter. This disparity is highly unlikely. We conclude that Evergrande is allocating development costs related to unsold parking spaces of its residential projects to its balance sheet and classifying them as investment properties. In doing so, Evergrande is artificially inflating its balance sheet assets to the tune of RMB 4bn."

226. In its Second Clarification Announcement published on the day after the publication of the Citron Report, Evergrande said that the methodology adopted in the Report was simply "wrong". It was erroneous and "highly misleading", it said, "to estimate the fair value of investment properties of the Company by using current rental income only"[29].

227. In considering these Citron Report allegations, Mr. Phenix made a number of observations. As he commented, because the Citron Report jumped around a lot and was sometimes confused, it was not the most straightforward task.

228. In respect of the allegation that Evergrande had overstated the value of its portfolio by at least RMB 10 billion, it was his opinion that the accounting policies adopted by Evergrande in respect of its investment properties were "standard industry policies", complying with Hong Kong accountancy standards. This, he said, was supported by the fact that the Independent Accountants' Report was prepared by Evergrande's accountants and the consolidated financial statements were audited by the same firm. The Citron Report allegations, he suggested, showed a lack of understanding of Hong Kong Accountancy Standard 40 [HKAS 40]. Mr. Phenix said that he could find no evidence of fraud as alleged.

229. In respect of the allegation that Evergrande earned less than 1% gross

[29] The detailed response is set out in para. 4.1 of the Second Clarification Announcement attached to this report as Annexure "G".

rental yield on its portfolio which suggested that the portfolio value was, "wildly overstated" by some 71%, Mr. Phenix was of the opinion that the methodology adopted by Citron Research integrated a number of false assumptions which made the analysis invalid.[30] Mr. Phenix was of the opinion that, while Evergrande's explanation contained in its Second Clarification Announcement did not fully explain the basis of the yield difference, it appeared nevertheless to be reasonable and consistent with the available evidence. In the result, he said, he was of the view that, on the evidence available at the date of publication of the Citron Report, there was no valid basis for the allegations.

230. As to the allegations that, despite such low yields, Evergrande's investment property portfolio had been marked up by the creation of "phantom" accounting profits on its income statement of RMB 9.5 billion and RMB 9.5 billion book value, Mr. Phenix was firmly of the view that Evergrande's valuation methodologies complied with the Hong Kong Accountancy Standards [HKAS 40] and that accordingly allegations of "phantom" profits/values had no basis and displayed (again) a "significant ignorance" of the requirements of HKAS 40.

231. During the course of cross-examination, it was put to Mr. Phenix that surely, on any reasonably informed reading, the allegation of "phantom" profits did not imply dishonesty but rather implied that, although the consolidated financial statements may be in accordance with relevant standards, they nevertheless revealed no more than a "paper" profit. In the opinion of the

[30] Mr. Phenix described the Citron Research analysis as applying an imputation technique to reverse-calculate the allegedly 'real' value of the investment property portfolio by applying an allegedly comparable rental yield to Evergrande's reported income and costs for this business segment.

Tribunal, read in the context of the allegation of "fraudulent accounting", the description "phantom" carried with it a more unnerving implication, namely, that the figures put out by Evergrande were illusory and, as such, to be of no substance.

232. Mr. Phenix testified that, in his opinion, the allegations made by Citron Research revealed a level of ignorance that would, on consideration, be identified by most professional analysts working in that specific area but not by others or by the average investor. As he put it, if you are a professional investor –

> "… you would be familiar with how property is valued, and you would be aware that under the accounting standards you can either chose a cost basis for investment property or you can chose a fair value. If you chose a fair value, you revalue. That is what gave rise to the 9.5 billion increase in its [Evergrande's] value which he [Mr. Left] says is wrong in some way. A professional property analyst, a professional analyst, an adviser maybe, maybe even a general property investor, would know that that is what everyone does."

233. Mr. Phenix continued by saying that this increase in value to RMB 9.5 billion would be understood by professional analysts not as fraudulent accounting because it was not fraudulent. It was *required* by the accounting standards. As to more general investors, he commented that, even if they attempted to understand the complexities, they would be "frightened" by the general tone of the allegations.

234. As to the allegations that Evergrande had recorded "RMB 9.5 billion of mark-to-market on its investment property portfolio (being 29% of the Company's reported shareholders' equity) with no specific details being disclosed as to how such gains had been achieved, Mr. Phenix was of the view that the disclosures – while complying with the relevant accountancy standards – were in fact sparse and did not therefore assist in enabling an "informed analysis". But that position of "minimal disclosures", he said, made the strong assertions of Citron Research – that of "fraudulent accounting" and the creation of "phantom" values even more "imprudent" and "unprofessional". As he expressed it, if person seeks to conduct an analysis of the finances of a company listed on the Hong Kong Stock Exchange, he must – for a start – have an understanding of the relevant accounting standards. If a person does not have such an understanding of these (or, for example, of other issues that may be relevant such as the Listing Rules or the relevant statutory provisions) then he should not comment on them. Mr. Phenix built on this by saying that, if you are a professional analyst, then the proper thing to do is to go to the company and seek clarification. As he expressed it:

> "if you are a professional, you would certainly pursue it with the company, especially if you are going to make allegations of fraudulent accounting… that is quite a severe statement to make".

235. The Tribunal pauses here to record that, in the course of final submissions, Mr. Li, on behalf of Mr. Left, made the submission that there had been a fundamental confusion in the SFC case, and in the testimony of its expert

witnesses in approaching the case on the basis that Mr. Left was a "professional in the industry" and "should know better". Mr. Left, it was said, was not a licensed person in Hong Kong, he was not director, substantial shareholder or in any way an insider to Evergrande. He was a complete outsider. Mr. Left made clear that his comments were based on public information; he cited relevant sources. Readers of the Citron Report were free to check those sources and to consider the logic of Mr. Left's analyses, Mr. Left was no more than a public investor who had the courage of his convictions. He made his trading decision on it and shared it on the Internet. By seeking to classify Mr. Left as a professional, it was submitted, a wrong standard was being applied, one that was too stringent. It was also resulting in a confusion between falsity and quality.

236. While the Tribunal accepts that Mr. Left was not an insider nor was he a licensed person, it has difficulty accepting that he pretended to be no more than a public investor with the courage of his convictions. As stated earlier, Citron Research (of which he was the principal) held itself out as having a history of identifying fraud in corporations; it held out that it had been cited in numerous leading financial journals and had successfully (so it was implied) defended court actions in respect of its work. This, on any ordinary reading, suggests a very particular level of expertise appropriate in its analysis of the Evergrande finances. Nor can it be ignored that Citron Research chose to make allegations of the most severe nature against Evergrande and to publish those allegations on the Internet even though it had not before (on the evidence) made any formal analysis of any Hong Kong listed company. Surely, in such circumstances, being a stranger to the statutory and regulatory context in which

Evergrande was obliged to present its financial information, there was an obligation placed on Citron Research to ensure it had an understanding of that context. Such an obligation is to be measured according to the relevant circumstances and the Tribunal has reached its determinations on this basis.

237. In respect of the allegations that Evergrande had underreported its development costs by "capitalizing costs onto its balance sheet as investment property", Mr. Phenix testified that the answer supplied by Evergrande in its Second Clarification Announcement correctly put the lie to such allegations. Again, said Mr. Phenix, these allegations by Citron Research revealed a "significant ignorance" of HKAS 40.

238. In the Citron Report, in respect of this matter of understating development costs, the conclusion was reached that Evergrande had allocated development costs related to unsold parking spaces to its balance sheet as investment properties thereby inflating its balance sheet assets by an amount of about RMB 4 billion. In answering this assertion, Evergrande stated in the Second Clarification Announcement that –

> "When calculating the unit cost of the investment properties, it was assumed that the gross floor area of a car parking space is 10 square metres. This assumption is completely unreasonable and reflects the severe lack of experience in the industry of the author of the Report. In fact, besides the area occupied by the parked car, the gross floor area of car parking space should also include a portion of the public road of the car park. Therefore, the gross floor area of each car parking space should be approximately 25 to

30 square metres."

239. In supporting this answer, Mr. Phenix commented that, on the Citron Research assumption that parking spaces were 10 square metres, it would not be possible to open the doors of the cars. It was, he said, "obviously nonsense".

240. In respect of the second cluster of allegations, it was Mr. Phenix's opinion that, again, having looked to see whether there may have been evidence of fraud buried in the consolidated financial statements, he found none. In short, allegations of fraudulent accounting in respect of the second cluster were without foundation.

241. In reviewing all the evidence related to what Mr. Phenix described as the second cluster of points dealing with technical accountancy issues, the Tribunal is satisfied that Mr. Phenix's analysis is correct. On the basis of the evidence available at the time, the allegations made by Citron Research – allegations of "fraudulent accounting" intended to mask the Evergrande's true financial position – displayed a significant ignorance of the accountancy standards that Evergrande was obliged to follow. In the result, the core allegations made were false and/or misleading as to material facts.

242. In coming to this determination, the Tribunal has at all times considered matters in full context; for example, in addition to those witnesses already cited, by having regard to the support given by a number of professional analysts who themselves found the Citron Report to be flawed and published their findings in answer to the Report.

243. By way of summary, for the reasons given, the Tribunal is satisfied that it has been demonstrated that the core allegations made in the Citron Report – those being the allegations considered in this report – alleging that Evergrande was “insolvent” or “essentially insolvent” and that it had been culpable of fraudulent accounting in order to mask its true financial position were false and/or misleading as to material facts.

CHAPTER 6

THE FOURTH REQUISITE ELEMENT OF S.277(1)

Proving a culpable state of mind, namely, that Mr. Left knew, or was reckless, or negligent, as to whether the information was false or misleading as to a material fact

Knowledge

244. On behalf of the SFC, Mr. Duncan conceded in his final submissions that actual knowledge on the part of Mr. Left had not been established. The Tribunal agrees.

Recklessness

245. As set out earlier in this Report, if Mr. Left is to be found reckless, the Tribunal must be satisfied that three matters fall to be answered in the affirmative. First, that when Mr. Left came to publish the Citron Report he was aware of the risk that the information in it (which is the subject of these proceedings) was false or misleading as to material facts. Second, that he was aware that in the circumstances the risk was of such substance that it was unreasonable to ignore it. Third, that nevertheless he went ahead and published the Report.

246. Can the inference be drawn, one that is a compelling inference on the facts, that, when he came to publish the Citron Report, Mr. Left must have been aware of the risk that allegations made in the Report were false and/or misleading as to material facts?

247. In this regard, the Tribunal has taken into account that the provenance of the draft was entirely unknown. Its authorship was anonymous. There was no indication therefore of the background of the author or his or her motives. Bearing in mind the sensationalist nature of the allegations made, it had to be as likely as not that the draft was penned by a person (or persons) bearing a grudge as it was penned by a person (or persons) seeking no more than an objective and fair exposition. Mr. Left had many years of experience in publishing corporate commentaries, seemingly specializing in hunting down corporate fraud. He must therefore have appreciated that anonymous reports of this kind – making allegations of fraud, payment of bribes and other illegal dealings, required careful scrutiny. Indeed, it was Mr. Left's case that he did go through a careful verification exercise. He would not have done that unless he was aware of the real risk in the circumstances that the allegations made in the draft were false and/or misleading as to material facts.

248. Can the inference be drawn, one that is a compelling inference on the facts, that Mr. Left was aware that in the circumstances the risk was of such substance that it was unreasonable to ignore it?

249. In this regard, the Tribunal has had no difficulty in concluding that in the circumstances Mr. Left must have appreciated that the risk was of such substance that it could not be ignored. The allegations made were extensive and sensationalist in nature. They spoke of a company that had abused the market and, in order to try and disguise the fact that it was in a state of insolvency, had resorted to fraudulent accounting. As the Tribunal has noted earlier, two fundamentally toxic elements were alleged in the draft, that of a company under severest financial stress and that of a company that had resorted to deceiving its shareholders and the investing public by resorting to fraudulent accounting. If there was clear and unimpeachable evidence it would perhaps have been different. But these allegations were based on a true understanding of complex accountancy regulations and standards, there being no evidence that the author of the draft had any expertise in this area. In such circumstances, quite clearly, the draft had to be approached on the basis that there was a real risk that it had been motivated in bad faith and contained at the very least distortions and/or exaggerations going to material facts.

250. In addition, when, at some stage of the process, Mr. Left determined on a short selling exercise, he must have appreciated the real need to ensure that the draft could be relied upon, and acted upon, in order to avoid any accusation that he had attempted to exploit what he knew to be suspect allegations to advance his own interests.

251. Can the inference be drawn, one that is a compelling inference on the facts, that Mr. Left nevertheless went ahead and published the Citron Report.

252. The Tribunal has concluded that it is a compelling inference that, when Mr. Left published the Citron Report, he consciously disregarded the real risk that the Report, even after his amendments, was false and/or misleading as to material facts. In this regard, what cannot be ignored is that the allegations contained in the (anonymous) draft were based on a supposed understanding of the relevant accountancy regulations and standards, these being of some complexity and in important respects particular to Hong Kong. Yet, on the evidence, it does not appear that Mr. Left, in the conduct of his verification exercise, took any steps to secure expert advice as to those regulations and standards. Nor, in respect of relevant matters, did he decide to approach Evergrande itself for clarification of matters. Mr. Left was not himself an expert in such matters. Nor was there any basis to suppose that the anonymous author of the draft possessed such expertise. In the circumstances, Mr. Left must have appreciated the real risk that at least a number of the allegations made in the draft, those allegations being based on technical accountancy issues, were made in ignorance of the relevant accountancy regulations and standards or had (perhaps because of dubious motives) simply ignored them. As it is, of course, the Tribunal has concluded that a number of the core allegations made in the draft and in the Citron Report itself displayed a basic ignorance of the relevant accountancy regulations and standards. Yet Mr. Left chose not to take the most obvious precaution of seeking expert advice. He went ahead without such advice while still retaining the sensationalist language of the draft, language that, of itself, he must have appreciated would cause a degree of consternation among members of the general investing public.

253. In all the circumstances, the Tribunal is satisfied that, when he published the Citron Report, Mr. Left consciously disregarded the real risk that the Report was false and/or misleading as to material facts. He was reckless in his conduct.

Negligence.

254. If the Tribunal is wrong in concluding that Mr. Left was reckless, it is satisfied that, – for the reasons set out above – in compiling and publishing the Citron Report, Mr. Left failed to exercise that level of care to avoid the inclusion of false and/or misleading information as to material facts that is realistically required of a reasonably prudent person who has chosen to carry out the function of a market commentator and/or analyst. Alternatively, therefore, he was negligent.

CHAPTER 7

SUMMARY OF THE TRIBUNAL'S CONCLUSIONS IN RESPECT OF CULPABILITY

255. By way of a summary only, for the reasons set out in the body of this report, the Tribunal has determined that Mr. Left is culpable of market misconduct within the meaning of s.277 of Part XIII of the Ordinance in that, in accordance with the terms of that section –

(a) Mr. Left published the Citron Report and thereby disseminated the information contained in it;

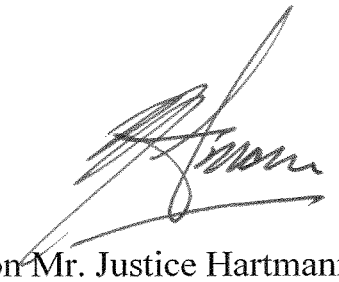
(b) that certain of the information contained in it, namely, that Evergrande had been culpable of 'fraudulent accounting' and that in reality it was 'insolvent', was likely to impact on the Hong Kong market in one or more of the ways set out in s.277(1);

(c) that such information was false and/or misleading as to material facts or through the omission of material facts;

(d) that Mr. Left was reckless as to whether such information was false and/or misleading as to material facts or through the omission of material facts;

(e) that, if not reckless, Mr. Left was negligent as to whether such information was false and/or misleading as to material facts or through the omission of material facts.

256. That the Tribunal will hear from the parties on a date to be agreed as to consequential orders. In this regard, the parties are to submit suggested directions within 21 days of the date of publication of this report.



The Hon Mr. Justice Hartmann NPJ

(Chairman)

Mr. Kwok Kam Hoi

(Member)

Dr. Wong Chak Sham, Michael

(Member)

Dated 26 August 2016