EXECUTIVE SUMMARY

A. Our Appointment and Terms of Reference

1. China Aviation Oil (Singapore) Corporation Ltd (the "Company") was incorporated in Singapore on 26 May 1993 as a joint venture between what was its parent company at that time, CAOSC, the China Foreign Trade Transport Corporation and Neptune Orient Lines Ltd. The Company was listed on the Exchange on 6 December 2001.

2. We were appointed on 30 November 2004 by the Company at the direction of Singapore Exchange Limited as Special Auditors under Rule 704(12) of the Listing Rules to investigate the affairs of the Company relating to the oil trading losses that it suffered and to report our findings to the Singapore Exchange Limited.

3. On 6 December 2004, at our request, the Company appointed Messrs Tan Kok Quan Partnership as our Singapore Law Counsel and Messrs Jones Day as our International Counsel, to assist in our investigation.

4. Our terms of reference are to:

    4.1 investigate the circumstances which gave rise to the substantial losses that were incurred in oil trading, including the trading of options and other derivatives, that was carried out or entered into by the Company;

    4.2 review the internal controls, risk management and governance policies that were in place in the Company for oil trading, including the trading of options and other derivatives, and the governance policies of the Company generally; and

    4.3 ascertain whether the substantial losses arising from the oil trading, including the trading of options and other derivatives, were properly accounted for in the correct accounting period and in accordance with the SAS or the FRS, as the case may be[1].

5 The investigation required us to undertake:

    5.1 the review of a substantial number of documents, including several hundred thousand emails and several thousand primary documents (many of which were in Chinese[2]) which are in the possession of the Company and various third parties who had interacted with the Company; and

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[1] In 2002, the applicable accounting framework was the SAS, which preceded the FRS. In so far as matters in this report are concerned, there was no material difference between the relevant provisions of the SAS and FRS.

[2] Translations of Chinese emails and/or documents were undertaken by an in-house team of translators and members of our investigation team who had a certain degree of proficiency in the language.

5.2 interviews with many individuals, both within and outside the Company, who were in a position to provide relevant information. A list of individuals together with their legal representatives, if any, is set out in Appendix 1 of this report.

In total, a record comprising more than 2,000 pages of notes of interviews[3] and several thousand primary documents and emails[4] was compiled and formed the evidential basis for our conclusions and observations.

6. We should add that:

6.1 save where we have otherwise stated, we have accepted the authenticity of the documents that have been made available to us at face value unless there are reasons to suggest that these are inaccurate or incomplete;

6.2 where appropriate, we have rounded the numbers in this report to the nearest one decimal place;

6.3 as our appointment was not for the purpose of carrying out an audit of the financial information of the Company, we have not performed an audit in accordance with the SSA. In accordance with our terms of reference, we have primarily focused on the substantial losses that were incurred by the Company in its derivatives trading; and

6.4 all our requests made to those currently and/or previously employed by the Company for interviews were acceded to save in one instance involving Mr Tan Chin Boon. Mr Tan Chin Boon (the Company's Director of Banking Relations and Head of Risk Management until his resignation sometime in April 2003) declined our initial oral request for an interview by stating that he did not wish to get involved and he subsequently did not respond to our follow-up written requests for an interview.

7. While drafting this report, we formed provisional conclusions or observations of certain individuals or institutions whose conduct or evidence we had considered in the course of the investigation. Where we considered it appropriate that the individual(s) or institution(s) in question should have the opportunity to comment on or respond to our provisional conclusions or observations, they were invited to respond or comment as they wished, on relevant portions of this report, which were circulated to them. In preparing this report, we have taken into account all such responses and/or comments and reflected the same where we felt it to be germane[5]. In some instances, we have revised the terms of the provisional

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[3] Interviews were transcribed by us save for certain interviews with Mr Chen Jiulin where professional transcribers were engaged.

[4] This represented the key emails and primary documents that were distilled after the review exercise referred to paragraph 5 herein.

[5] We began to receive such responses and/or comments from various individuals and institutions from May 2005 onwards. In this report, such responses and comments, where taken into account by us, are generally identified as coming from "*notes*" and/or "*comments*" from a particular individual/institution on a particular date as the case may be.

conclusions or observations to take account of such responses and/or comments.

8. This report is confined to investigating the circumstances that gave rise to the substantial losses incurred by the Company in oil trading. We have sought to reconstruct the facts and circumstances leading to the current predicament of the Company, and to identify the cause(s) for the same. In the *"Statement of Phase 1 Findings"*, we had generally refrained from making an assessment of the individuals concerned. We had also refrained from commenting on the veracity of the evidence that was presented by the individuals we had interviewed as part of the investigation.

9. In this report, we have now addressed these matters. In doing so, we adopted the following approach (subject to the constraints set out later in this Executive Summary):

   9.1 we considered the conduct of these individuals from the perspective that the subject of our investigation was a company incorporated in Singapore and listed on the Singapore Exchange and that the individuals in question were subject to the laws and regulations of Singapore;

   9.2 we carefully assessed and weighed the evidence presented in the interviews against the documentary evidence that was provided to us for the purpose of the investigation to determine whether the assertions made or explanations offered were to be accepted; and

   9.3 in considering how the evidence weighed, we considered such matters as inherent logic, credibility, reasonableness and consistency. We also bore in mind the knowledge that the individual possessed or ought to have possessed, his background (in particular, his previous appointments), the purpose of his present appointment, the information, documents or external assistance that were available or ought to have been available to that individual, the documents that that individual generated or received (or ought to have generated or received), the significance of key events to that individual, and the behaviour that would reasonably be expected of that individual in the circumstances.

10. We have not:

   10.1 interviewed Mr Chen Kaibin and Mr Zhang Lianxi, who were also nominees of CAOHC to the Board and the PRC Independent Director Dr Yan Xue Tong. This is principally because these officers are generally not mentioned in any of the documents relevant to the substantial losses suffered by the Company in oil trading;

   10.2 interviewed officers from the CAOHC Executive Committee other than Mr Jia and Mr Chen. Mr Jia and Mr Chen were interviewed as they were directors of the Company;

   10.3 examined issues and events in October and November 2004 in connection with the acquisition by the Company of an interest in SPC

from Satya in view of the action commenced in the High Court by Satya against the Company[6];

10.4 examined the knowledge and motivations of the relevant individuals who were involved in the placement by CAOHC of 15% of the share capital of the Company which was registered in CAOHC's name on 20 October 2004; and

10.5 examined any breaches of any statutes and/or subsidiary legislation which may have been committed.

11. As Special Auditors, there were certain constraints on our ability to investigate and reconstruct the facts, in particular:

11.1 we did not have the right to access the documents in the possession of third parties or compel attendance of individuals to offer evidence relevant to the investigation; and

11.2 we did not have the power to take evidence under oath or affirmation.

12. We should also point out the following:

12.1 many of the interviewees were Chinese-speaking. This meant that these interviews were time-intensive and exacting in terms of having the interviewees understand the questions that were being posed and the documents that they were being asked to comment on, and discerning their responses accurately. Most of these interviewees had interpreters assigned to them by the Company. Further, as far as it was possible, these interviews were conducted by a team that had at least one member who was reasonably conversant in the Chinese language and who would assist in the translation process where necessary;

12.2 many of the documents that were reviewed were in Chinese. The translation of these documents was undertaken by an in-house team of translators and members of our team who had a certain degree of proficiency in the language. The process of translation again proved to be a time-intensive and exacting exercise; and

12.3 though we have attempted to be as complete as possible in the retrieval of relevant documents and in the interview process, within the constraints of our appointment, there are some matters that should be borne in mind when reviewing our conclusions and observations. First, CAOHC in general acceded to our requests for documents but we are unable to say if CAOHC had other documents in their possession which we were not aware of and hence had not asked for. Second, we have not been able to review documents in the possession of some third parties in view of the limitations of our appointment. Third, some institutions that we sought to

[6] Suit No. 967 of 2004/F in the High Court filed on 8 December 2004.

interview imposed conditions that we deemed unacceptable. We therefore declined to interview them.

B. Introduction

13. Some years following its incorporation in 1993 as a joint venture between CAOSC, The China Foreign Trade Transport Corporation and Neptune Orient Lines Ltd, on 14 February 1995 the Company became a wholly-owned subsidiary of CAOSC following that company's acquisition of the shareholdings of its former joint venturers. CAOSC is a large state-owned enterprise in the PRC. Its business at that time included the construction of jet fuel infrastructure, the procurement of jet fuel supply equipment, the supply of jet fuel to airports in the PRC, and the provision of refueling services to airplanes at airports in the PRC.

14. CAOSC's intention was to use the Company as its overseas procurement arm in importing fuel but for various reasons it was only on 1 July 1997 that the Company commenced its operations, sourcing jet fuel from the international oil markets for CAOSC. By 1998, the Company had started trading oil derivatives.

15. In 1998, the Company's total turnover amounted to approximately S$170.7 million yielding a net profit before tax of approximately S$7.1 million.

16. A year after commencing operations, the Company was conferred the AOT award by the Singapore Ministry of Trade and Industry. This was an endorsement of its performance as well as its contributions to the Singapore economy and entitled the Company to enjoy a concessionary tax rate of 10% on qualifying income for a period of 5 years with effect from 1 January 1998.

17. By the year 2000, the Company had gained 92% of the market for total jet fuel imports into the PRC. Reflecting this dominant position, for financial year 2000, the Company's turnover had already grown to approximately S$963.7 million and this was accompanied by an increase in net profit before tax to about S$16.2 million.

18. In July 2001, the Company applied to be listed on the Main Board of the Singapore Exchange and it was so listed on 6 December 2001. Following the listing, CAOSC's shareholding in the Company was reduced to 75%.

19. Sometime between 2002 and 2003, CAOSC's shareholding in the Company was transferred to CAOHC. We understand from the Company that this transfer was done in accordance with state regulations aimed at separating commercial enterprises from the PRC government and it was completed on 23 April 2003.

20. Following the restructuring exercise, CAOHC held the 75% shareholding in the Company and CAOSC became a subsidiary company of CAOHC. In connection with this restructuring exercise, there were also changes to the Board in March 2003, with officers of CAOSC (save for Mr Jia and Mr Chen) retiring from the Board to be replaced by their counterparts from CAOHC[7].

[7] The new Non-Executive Directors of the Company appointed were :

21. At the time of its listing, the Company was in the business of jet fuel procurement and trading of petroleum products such as jet fuel, gasoil, fuel oil, crude oil and plastics, and oil derivatives.

22. In line with its stated intention, at the time of listing, of expanding its business, the Company also used some of the net proceeds from the initial public offering for acquiring companies and making strategic investments that it believed complemented its businesses.

23. Vital to the profitability of the Company was the maintenance of its AOT status[8]. Under this program, the Company was eligible to enjoy the concessionary tax rate for various oil trading activities including in particular:

    23.1 purchasing and selling petroleum or petroleum products;

    23.2 purchasing and selling futures contracts and options contracts covering petroleum and petroleum products; and

    23.3 making and receiving payments under swaps, caps, collars, floors, swap options and other forms of over the counter instruments covering petroleum or petroleum products.

24. The Company's status as an AOT/GTP trader was later renewed and modified so that it became eligible for an even lower concessionary tax rate. At the same time, the Company was expected to undertake a certain volume of oil trading on an annualised basis. Such trading would include trading in physical cargo as well as in oil derivatives such as oil futures, swaps and options. Under the terms of the GTP, as reflected in a letter dated 16 July 2004 from International Enterprise Singapore, the Company was required to achieve a minimum cumulative physical trade turnover of $4,547 million and a minimum cumulative derivatives trade turnover of $13,641 million and to employ at least 15 international trading professionals by the end of December 2008.

C. <u>The Company's Business</u>

25. The Company's core business at the time of its listing was the procurement of jet fuel from overseas markets for distribution to the PRC civil aviation industry through CAOSC, its subsidiaries and its associated companies (the "Parent Group"). According to the Prospectus, CAOSC was the sole entity authorised by the PRC government to allocate the import quota for the import of jet fuel into the

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(a) Mr Li Yongji (Head of Assets and Financial Management Division in CAOHC);
(b) Ms Gu Yanfei (Head of Enterprise Planning and Development Division in CAOHC);
(c) Mr Chen Kaibin (Technical Supervisor and Director of Safety & Technology Division in CAOHC); and
(d) Mr Zhang Lianxi (Deputy Director of Procurement Division in CAOHC).

[8] At page 20 of the Prospectus under the Risk Factors Section, it was stated by the Company as follows, *"We are reliant on our GTP status. As [sic] the GTP scheme (formerly known as the AOT scheme), we are currently able to obtain preferential tax treatment, having to pay only a tax rate of 10% on the income derived from qualifying trading transactions of approved products in our business. However, the Singapore Trade Development Board reviews the GTP award every five years and we are unable to ensure that we will continue to maintain this status in future. The loss of this award will lead to an increase in tax expenses and affect our Company's profits."* The AOT award was subsequently renamed the GTP award in June 2001. The Company's GTP status was renewed sometime in mid 2003 for a further 5 years commencing 1 January 2003.

PRC. The Company's jet fuel procurement business was heavily dependent on the Parent Group as approximately 98.3% of all such jet fuel trades in financial year 2000 and virtually 100% from financial years 2001 to 2003 were with the Parent Group. The revenue from the jet fuel procurement business of the Company contributed to approximately 40% of the total revenue from physical trades of the Company for the financial years ended 31 December 2002 and 2003.

26. Apart from jet fuel procurement for the Parent Group, the Company also engaged in other forms of physical oil trading. The oil products that the Company traded were jet fuel, gasoil, fuel oil, crude oil and petrochemical products and such trading accounted for approximately 60% of the Company's total revenue from physical trades for the same period.

27. However, despite this, the gross profits and profit margins from the physical oil trading and jet fuel procurement businesses of the Company were in general decline from 2000 to 2003. This coincided with a period when its commissions for the jet fuel procurement business were negotiated down by 40%. Against this background, more emphasis was placed by the Company on its other areas of business such as its strategic investments and oil derivatives trading.

28. The Company did use some of the proceeds from the initial public offering to diversify and expand its businesses by acquiring companies and making strategic investments that complemented the core business of the Company. Aside from investments made earlier on, as late as August 2004, the Company entered into a conditional share purchase agreement to purchase from Satya its 20.6% shareholding in SPC. This is at present the subject of a suit taken out by Satya against the Company[9].

D. <u>The Company's Derivatives Trading</u>

29. The Company's oil derivatives business was described in the Prospectus as trading in paper swaps to hedge the price risk exposure associated with the Company's jet fuel and fuel oil cargoes, and in crude oil futures to hedge its crude oil cargoes.

30. In addition to trading derivatives for hedging, the Company also stated in the Prospectus that it engaged in opportunistic or speculative trading by taking open positions on derivatives instruments when its traders, based on their experience and analysis of the market, saw an opportunity to make gains from market movements. In fact this had been a part of the Company's business from at least 1999.

31. Until March 2002, the Company only traded futures and swaps for both speculative and hedging purposes. The Company first started trading in options on 20 March 2002. The initial options trades transacted from 20 March 2002 were back-to-back transactions carried out by the Company for certain PRC airline companies. On 28 March 2003, the Company commenced speculative options trading on its own account.

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[9] Suit No. 967 of 2004/F filed in the High Court on 8 December 2004.

32. There was a significant increase in the volume of derivatives that was being traded from 2002 to 2004 and at least by 2003, the volume of derivatives traded well exceeded the volume for physical trades. This was accompanied by an increase in the revenue generated from oil derivatives trading from 2001 to 2003, such revenue exceeding the revenue generated from physical oil trading from as early as 2001. In keeping with these trends, by November 2004, the Company had a total of 9 oil traders.

33. As noted above, a year after it commenced its back-to-back trades for the airline companies, the Company started speculative trading in options. This was in addition to its existing speculative trading activities in futures and swaps. The Audit Committee Report for 2003[10] indicated erroneously that the Company had commenced speculative options trading in 3Q 2003 and further that the Company was still developing standard operating procedures for options trading. In fact the RMM was never amended; nor were specific "standard operating procedures" developed to provide for and regulate the risks that were attendant upon options trading. For that matter, the procedures contemplated in the RMM in connection with the commencement of new product lines were never followed.

34. The trading strategies and decisions that the Company made from March 2003, at least in relation to its options trading portfolio, were dictated by the view that it had of the likely trend in oil prices. The Company generally held a bullish view of oil prices up to the end of 3Q 2003 and had a bearish outlook after that. While the Company's assessment of the trend in oil prices for 2003 proved largely correct, unfortunately the same could not be said for the assessment it made of price trends from late 2003 through 2004. This incorrect assessment was a significant contributor to the losses that the Company later incurred.

35. In 4Q 2003, the MTM value of the Company's options trades deteriorated. In early January 2004, there was a sharp rise in Kero prices[11] which caused the MTM value of the structured collars that had been entered into by the Company in 4Q 2003 and of trades it executed in early January 2004 to deteriorate further. In addition, some of these structured collars had extendible features. These options had been sold by the Company on the assumption that oil prices would trend downwards, but as oil prices were in fact rising, the counterparties exercised their rights to extend the options thereby increasing the potential losses of the Company. As prices continued to trend upwards, the options had an increasing negative MTM value. These options were maturing in 1Q 2004. This was probably an early defining moment in the events that were to transpire. Those managing the Company took the view (incorrectly) that unless the losses were realised, there was no requirement to account for them in its financial statements. To avoid realising the losses and in the hope that the situation could be managed, the Company entered into a restructuring of its options portfolio with J. Aron on 26 January 2004. Further, the Company (again incorrectly) did not book the losses that were realised upon the restructuring when closing-out the loss-making near-dated options.

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[10] This report was presented at the Audit Committee Meeting on 18 February 2004 by the External Auditors.

[11] Information is derived from Bloomberg.

36. The restructuring was effected by the purchase of options contracts to close-out the loss-making short-dated options and then financing the cost of this exercise by selling longer dated calls and puts with higher strike prices and volumes stretching from 2Q 2004 to 1Q 2005 and extendibles stretching further to 4Q 2005. The principal idea was to achieve a zero net cashflow on the erroneous premise that the loss resulting from closing-out the loss-making options need not be reflected in the financial statements. The new trades that were entered into as a result of the restructuring significantly increased the level of exposure of the Company because of the greater volume of such transactions and the longer option periods.

37. The MTM value of the new trades that were entered into under the January restructuring deteriorated with the continuing rise in oil prices. This resulted in margin calls being made on the Company from May 2004 and to which it responded initially by procuring SBLCs issued in favour of the counterparty. With oil prices continuing their upward trend, the losses mounted and by June 2004, it was felt that the trades that were maturing in 3Q and 4Q 2004 had to be restructured for the same reasons as those for the January restructuring. A second major restructuring was thus undertaken by the Company on or about 28 June 2004 with J. Aron again using the same broad approach.

38. As oil prices continued to move upwards after the June restructuring, the negative MTM value of the Company's options portfolio continued to deteriorate ever more rapidly. This resulted in the Company facing more margin calls which were met largely by the Company depositing cash with the counterparties. A further restructuring exercise (this time with a number of different counterparties, excluding J. Aron) was done in September 2004. The Company eventually ran out of funds to support the margin calls.

39. It is noted that the Company in effect traded options speculatively on its own account for just about 10 months from March 2003 to January 2004. From January 2004 when it first embarked on the course of restructuring its options portfolio, no new transactions were entered into other than those transacted as part of the restructuring. It is also noted that in a short span of about 5 years the Company had unwittingly or otherwise, changed its primary business model from one that was rooted in physical trading with some hedging paper trades and some speculative trades to a model that was heavily weighted the other way. Moreover, the nature of its speculative portfolio itself changed within a short time from relatively straightforward transactions in futures and swaps to exotic options. In doing so, the Company was apparently oblivious to the very significantly different risks that applied to a seller of options for whom the downside risk is potentially unlimited as opposed to a buyer of options whose risk is limited to the premium cost. The risks manifested themselves in January 2004 with losses on the options contracts which therefore led to the Company considering and executing the January restructuring. This restructuring proved to be a defining moment. In a misguided attempt to avoid recording and reporting losses, the Company assumed a greater risk exposure by selling options with a very high risk profile and long tenure to raise premiums to cover the cost of closing-out the loss-making options contracts. The Company then exacerbated the situation manifold in the restructurings that followed in June and September

2004 for the same reasons. This was an imprudent course to take and it was ultimately the immediate cause of the Company's predicament.

E. Incorrect Valuation of Options Portfolio

40. Throughout this period, the Company seriously erred in its valuation of its options portfolio. The value of the option is the total of the intrinsic value and the time value of the option. The intrinsic value represents the net positive amount that an option would realise if it was exercised immediately. This would be the difference between the forward price and the strike price. The value of an option is not static given that the forward price may be volatile over the period of the option. Hence the longer the period of the option, the bigger the risk the seller of the option assumes. The time value has, *inter alia*, a correlation to the time to maturity of the option. When pricing an option with a long tenure to maturity (as was common with the options sold under the restructuring exercises) it is key that the time value of the option is appropriately factored into the valuation. A failure to recognise the time value of the option would result in its incorrect valuation.

41. We recognise that even taking the time value of the options into account, the actual valuation that is arrived at of a given option may fall within a range as there is inevitably an element of judgment involved in valuing options. The volatility curves are integral to the application of the various valuation models (all of which take into account time value) that exist to value options. The volatility curves of commodities that are not traded on exchanges (for example Kero) are formulated based on an assessment of current information in respect of the prices of traded options available to the counterparty. In making this assessment, the counterparty makes a judgment as to the implied volatility of the prices of options over a period of time.

42. These factors are collectively taken on board in various valuation models which are used to determine the value of the option. These valuation models are widely accepted as giving a fair and accurate assessment of the value of the option before maturity, working of course, on the bases of certain assumptions and data.

43. In our view the Company seriously erred in the way it valued options from the inception of its trading in options in 2002 which then involved back-to-back transactions for and with the airline companies. The fundamental error that the Company made was to take only the intrinsic value in arriving at the MTM value of the options. This meant that the options were valued based on the difference between the forward price and the strike price of the underlying commodity and ignoring their time value.

44. By June 2004 at the latest, it must have been apparent to the Company that its valuation of its options portfolio was incorrect[12]. The error would have been

[12] We have sighted an email dated 7 January 2004 from a counterparty advising the Company of its valuation of certain outstanding options. This could in fact have alerted the Company to the inaccuracies in its MTM valuation methodology. Further, the External Auditors have informed us that they informed Mr Lim during the audit period for the Financial Statements for 2003 that the Company's MTM valuations should take into account time value. This is disputed as elaborated in the body of the report.

further highlighted by the margin calls the Company had started receiving in May 2004. The Company did not dispute, amend or question these margin calls, and indeed continued to meet these margin calls; yet curiously it did not correct its method of valuing options. The error would also have become apparent in the discussions that preceded the June restructuring.

F. Risks and Risk Management

45. By the time the Company applied for permission to conduct a public offering of its shares in 2001, it was already engaged in speculative trading in futures and swaps. Even if this was not as significant a part of the Company's business as it would later become, there can be no doubt that those managing the Company were aware of the risks that such trading entailed.

46. It is clear that at the time of the listing, the Company was aware of and informed the investing public to have regard, among other things, to the risk of volatility in oil prices and the risks inherent in speculative derivatives trading in particular the risk of significant movements in oil prices against open positions; and even the risk of risk management guidelines not being observed by traders.

47. We were informed by DBS, who were the Issue Managers for the Company's listing, that because of losses that had been encountered in speculative derivatives trading in 2000, the Company adopted enhanced risk management procedures and the Prospectus placed much emphasis on this.

48. Subsequently, in the Annual Report for 2001, it was noted that the Company had engaged E&Y to develop a comprehensive Risk Management Procedure Manual modeled on the best industry practices of the major international oil companies. The RMM was developed with the assistance of E&Y in the course of 2002. It was approved and adopted by the Board on 14 March 2002. The Minutes of the Board Meeting held on 14 March 2002 state that the Board and the Audit Committee had not had sufficient time to digest the contents of the RMM and lacked expertise to comment on the figures. The RMM was thus approved on a *"test run"* basis. There appears to have been no subsequent review by the Board and it was implemented a month later on 15 April 2002. However, the Annual Report for that year informed its readers that the Company had adopted this manual and that it was *"modeled on the best industry practices used by the major international oil companies",* without giving any indication that the adoption had been done on a provisional basis because of a lack of time and/or expertise on the part of the Board and the Audit Committee to digest the RMM and comment on the figures. Nor was there any indication given as to whether or not these concerns were later addressed and overcome.

49. The Annual Report for 2003 further indicated that the Risk Management framework in the Company had been enhanced with a multi-layer approach that ostensibly commenced with the divisional heads, the "independent" Risk Management Committee and the IAD, and then involved the Audit Committee before culminating at the Board.

50. Notwithstanding this, the RMM was not written for and did not address options trading. If the RMM had been written for options trading,

50.1 it should have stipulated trading limits for options. No such limits were set. Instead, attempts were made to set, *inter alia*, the trading limits for options only on 31 December 2003 and 2 January 2004. These were attempts by Ms Cindy Chong (who was the Company's Head of Banking Relations and Risk Management) but these limits were not understood by her and were not in any case correctly set. Further, by the time the decision to restructure the portfolio in January 2004 was made, the MTM value of the options portfolio was significantly in the negative and had already breached the said trading limits;

50.2 there should have been an attempt to distinguish between bought and sold options as they carried very different risks:

(a) for the buyer, a bought option carried only the risk of a loss of the premium paid for the option in the event it was not exercised; but

(b) for the seller, a sold option carried the risk of unlimited exposure if it was exercised since the market price at the time of exercise could vary indefinitely against the exercise price;

50.3 there should have been an attempt to distinguish between the different types of options which were of varying complexity and thus carried with them varying degrees of risks;

50.4 a procedure ought to have been laid down as to what hedging mechanisms were to be utilised to address the potential downsides to the positions taken by the Company; and

50.5 a procedure ought to have been laid down for measuring Value-at-Risk and the *"Greeks"*, which were key techniques in respectively measuring the market risks of derivatives in general and options in particular[13].

The absence of the above meant that the RMM was not *"tailored"* for options trading.

51. In our view, the commencement of options trading would have constituted the entry into a new business or commencement of trading in a new product. If the Company had intended to commence such trading, it should have followed the specific provisions contained in the RMM which, *inter alia*, required that such new products/businesses be approved by the Board.

52. Moreover, as a general proposition, it seems trite that the Board and/or senior management ought to understand and be fully aware of the risks associated with the Company's business activities, regardless of how complex or sophisticated these activities may be whether due to their inherent nature or otherwise. The Board and senior management should then take the necessary measures to ensure that such activities are:

[13] This is discussed in greater detail in Appendix 4.

52.1 conducted in a safe and sound manner and in-line with high standards of professionalism and sound business practice;

52.2 consistent with the Company's overall risk management philosophy and business strategy; and

52.3 subject to adequate risk management and internal controls, which entails the Company having proper policies and procedures, risk management systems and independent oversight and control processes.

53. It is a matter for the Board to approve policies pertaining to the evaluation and management of risks related to the spectrum of the Company's business activities. It follows from all this that Board members need to understand the business activities of the Company in order to have a meaningful understanding of the risks associated with the business activities, how these risks ought to be managed and whether they are being managed appropriately.

54. However, as noted above, it appears from the minutes of the Board meeting held on 14 March 2002 that, when the RMM was adopted, the Board, at least at that time, felt that it did not have sufficient time to digest the contents of the same and further felt that it lacked expertise to comment on the limits contained in the RMM. We have not seen any evidence that the Board subsequently educated itself on the RMM. If the Board was relying on E&Y to set appropriate risk limits, this was a fundamental error and not appropriate corporate governance. It was an even more fundamental error for the Board to have allowed the Company's derivatives trading activities to continue at that time when it felt it lacked the relevant expertise to set the relevant risk limits.

55. These matters all go to undermine the Company's representation that it had effective risk management procedures in place. Leaving this aside, in practice the execution of such procedures as did exist were beset by critical failures.

56. The traders were the front office for trading purposes. In our view, the front office failed to carry out its responsibilities in the following respects:

56.1 although there were no trading limits specifically set for options trading, the limits that were in place for trading as a whole served to define the Company's overall appetite for risk and ought to have been adhered to by the front office. However, the front office did not monitor its options trades to ensure that there was adherence to such the trading limits as did exist and this was one of the fundamental requirements under the RMM. Further, corrective measures were not taken to bring exposures within such limits once these had been breached;

56.2 specifically, the front office did not adhere to these trading limits after these had been exceeded in January 2004;

56.3 the front office failed to highlight the fact that the wrong valuation methodology for options was being applied;

56.4 the front office failed to advise others in the Company of the consequences and ramifications of the various restructuring exercises even though it was well placed to do so; and

56.5 at the material times, the key consideration behind the restructurings appears to have been to avoid crystallising the losses and on this basis not to reflect MTM losses in the books. We are clear that the MTM losses did have to be recorded and that any other approach was incorrect. There also appears to have been a misplaced hope that oil prices would ultimately correct allowing the Company to trade its way out of the losses. On the back of this incorrect approach to accounting for the losses and the misplaced hope as to oil prices, the front office did nothing to caution against putting the Company at risk.

57. The Risk Controller occupied the middle office for trading purposes and was responsible for accurately recording the trades, and monitoring and reporting excesses. In practice, the middle office failed to:

57.1 correctly compute the MTM valuation of the Company's options portfolio. This was a critical failure in that the valuations used by the Company did not accurately reflect the potential losses the Company was facing;

57.2 accurately and/or consistently report the Company's options portfolio and its risk exposure;

57.3 properly utilise the resources available in the Kiodex software system to value and report the Company's options portfolio; and

57.4 apply key risk measurement techniques in respect of the Company's options trades and overall derivatives portfolio.

58. The finance department occupied the back office and was responsible for settlement of the trades. The back office clearly had the potential to play a critical role in identifying and then stopping activities that breached the permitted limits. In this respect, the back office also failed.

59. In the 7-month period from May through November 2004, a total of approximately $381 million was paid to meet margin calls arising from the mounting MTM losses. The satisfaction of these margin calls extended even to using facilities which the Board and the Audit Committee had directed were to be used for some other purpose. That all this was done to meet obligations arising under and as a result of the restructuring transactions which had never been approved or notified to the Board and which Independent Directors were apparently unaware of, evidences a grave failure of controls.

60. Moreover, the back office failed to:

60.1 ensure that basic safeguards and controls inherent in having counter signatories for cash payments (above a certain amount) and the issuance of SBLC were adhered to; and

60.2 accurately report the MTM losses in the Company's financial statements.

61. The Company in its Annual Reports had repeatedly touted the RMM as a state-of-the-art risk management manual embodying best practices in the industry. At the core of the RMM was the RMC and repeated assertions had been made of the independence of the RMC. In reality, the RMC failed in all material respects. In particular:

61.1 the RMC failed to carry out the appropriate procedures at the time the Company embarked on this new product line. This was a critical failure since there was none of the analytical and evaluative work that was expected to precede the commencement of such trading. In fact, options trading commenced with a casual exchange of emails between Mr Gerard Rigby (the principal trader involved in options trading and who is referred to here as "Mr Rigby") and Mr Chen with the sole concern being whether this could be a profitable venture;

61.2 trading having commenced, the RMC failed to understand options or ensure that the options portfolio was appropriately valued though at some stage most of the individual members of the RMC ought to have been aware, that the valuation methodology being applied was inappropriate having regard among other things to the fact that the Company started receiving margin calls in May 2004, as well as the discussions that took place between members of the RMC and J. Aron in connection with the restructuring exercises in particular that in June 2004 when these discussions extended to how the Company was treating its MTM losses in its financial statements;

61.3 the RMC failed to ensure that appropriate limits were set for options trading;

61.4 the RMC failed to ensure accurate reporting of the options trades;

61.5 the RMC failed to report any issues regarding the Company's options trades to the IAD until sometime in May 2004. This was even though the IAD was presented as the RMC's reporting line in the Annual Report for 2003. The Risk Controller even informed us that she probably would not have furnished the relevant information to the IAD if asked;

61.6 the RMC gave reports to the Audit Committee as regards the Company's derivatives trading which effectively concealed from the Audit Committee the issues which the Company had faced as regards its options trades;

61.7 the RMC did not report on the Company's options trades and the losses sustained as a result of the same to the Board. In fact, there is evidence supporting an assertion made by the Company's Risk Controller, Ms Elena Ng (referred to here as "Ms Ng") that the RMC members and Mr Rigby had decided to keep the MTM losses in the Company's options portfolio to themselves and Mr Chen;

61.8 the RMC failed to oversee adherence to the overall limits for trading or to report the excesses which the Company engaged in by restructuring its options portfolio; and

61.9 through the January and June restructurings , the RMC failed to consider or advise on the imprudence of the restructuring exercises and the greatly increased risks the Company was being exposed to or to advise that the losses be cut.

62. The IAD was clearly a division which largely existed in name only. It appears that Mr Adrian Chang (who was the Head of the Internal Audit Division and is referred to here as “Mr Chang”), did not make regular reports to the Audit Committee and his reports were, in any event, repetitive and perfunctory in content. Further, the reports were inaccurate in that they gave the impression that the Company’s internal controls were operating satisfactorily when this was not the case. There is evidence to show that Mr Chang was aware of the inaccuracies of these reports.

63. Lastly, on this issue, as the Managing Director and Chief Executive Officer of the Company, Mr Chen must bear the primary responsibility for:

63.1 the Company commencing options trading without understanding precisely what it entailed and without ensuring that there was a proper and prior evaluation of the risks involved;

63.2 having committed the Company to unacceptably imprudent risks in the restructurings which eventually proved financially disastrous for the Company;

63.3 failing to report the Company’s MTM losses in its financial results. Mr Chen was clearly aware that there were such MTM losses since he was involved in the January, June and September restructurings. He was informed that these MTM losses would have to be taken into account in the Company’s financial results by 2 emails sent by Mr Peter Lim (who was the Head of Finance Division and is referred to here as “Mr Lim”) on 17 May 2004 and 4 October 2004. Yet he allowed announcements to be made as regards the Company’s financial results which did not reflect these losses; and

63.4 fostering a culture of secrecy. Arising from this culture of secrecy, attempts were made to conceal the losses on the options trades (which led to and resulted from the restructuring exercises which in turn led to further losses) from the Board and the Audit Committee.

64. The consistent impression of those who worked with Mr Chen was that he was propelled by a need to surpass his past achievements as CEO. It appeared that Mr Chen had plans to turn the Company into an international oil major. The evidence that we have reviewed suggests that Mr Chen was motivated to conceal the Company’s MTM losses as a matter of personal ambition. He himself had admitted that he did not disclose these losses because he did not wish for the price of the Company’s shares to be affected. He claimed that he had made

these mistakes because he had the interests of the Company in mind. These assertions, however, show that Mr Chen had a distorted view of what constituted the interests of the Company.

65. The Company claimed that it made *"ongoing efforts to optimally manage risk"* and held itself out as having an impressive 3-tiered *"internal control supervision structure"* comprising of the *"Heads of Division"*, the RMC and the IAD. It is however evident from the foregoing that there were critical failures at every tier of this structure. We have already noted that there were no trading limits specifically set for options trading. This was also true of the risk management procedures and controls as a whole. There were trading limits that were in place for trading as a whole and although these limits were formulated without having any regard to the options trading that the Company later embarked upon, they served to define the Company's overall appetite for risk and ought to have been adhered to by the front office. However, to the extent that there were any such risk management procedures and controls that could have applied to the options trades, these were readily overridden by management[14].

G. Recognition of Speculative Derivatives in Financial Statements and Corporate Disclosures

66. For the accounting periods under review, the FRS[15] did not specifically prescribe a method of recognising and measuring derivatives. However, given its adoption of FRS and in the absence of specific guidance on derivatives, the Company should have conducted itself in accordance with the statement of general principle in FRS 1 and thus ought to have adopted an accounting treatment and valuation method for derivatives that accorded with industry standards and practices assuming, of course, that the same did not contradict the FRS Framework.

67. In fact, the Company's accounting for speculative options was not consistent with accepted industry practices. We have noted that the MTM valuation methodology adopted by the Company was incorrect. It was also inconsistent with paragraph 82 of FRS 32 *Financial Instruments: Disclosure and Presentation,* which advocates the use of option pricing models for the purpose of valuing options in the absence of reliable market prices. Option pricing models commonly used by market participants include the Black-Scholes options model, Black '76 options pricing model, Monte-Carlo simulations and the Cox-Ross-Rubinstein binomial model. None of these were used by the Company.

68. For the year ended 31 December 2002 and thereafter, the Financial Statements were incorrect in that the MTM value of the options transacted by the Company were not duly accounted for. As for errors in the Company's reported earnings in the 3 quarters of 2004 these are as follows:

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[14] We refer here to senior executives of the Company including in particular Mr Chen, the Managing Director, Mr Gerard Rigby, the principal trader involved in options trading, Mr Peter Lim, the Head of Finance Division, Ms Cindy Chong, the Head of Banking Relations and Risk Management Division, Ms Elena Ng, the Risk Controller and Mr Eddie Heng, the Finance Manager.

[15] In 2002, the applicable accounting framework was the SAS, which preceded the FRS. In so far as matters discussed in this report are concerned, there was no material difference between the relevant provisions of the SAS and FRS.

Reported and Adjusted PBT in 2004

S$ million	1Q	2Q	YTD June 04	3Q	YTD September 04
Reported PBT	19.0	19.3	38.3	11.3	49.6
Adjusted PBT	(6.4)	(58.0)	(64.4)	(314.6)	(379.0)

69. The Company's reported earnings in 2004 were therefore grossly inaccurate.

70. On the issue of disclosure of material information to the investing public, the CG Code recommends that the directors should provide shareholders of the company with a balanced and understandable assessment of the company's performance, position and prospects on a quarterly basis. This responsibility extends to interim and other price sensitive public reports and reports to regulators (if required).

71. In addition, the CG Code recommends that the company should engage in regular, effective and fair communications with shareholders. Where there is inadvertent disclosure made to a selected group, the company should make the same disclosure publicly to all others.

72. In the public announcements made by the Company in 2004, pertinent information relating to the Company's options trading activities and positions, in particular as to the losses that had been sustained as a result of such trading or the fact that the Company had entered into repeated restructuring exercises and the consequences that followed from these exercises, was not disclosed to the shareholders. In fact, none of the announcements at the relevant times hinted at any problems in the Company. Instead, there were always assurances of a robust risk management framework and of optimistic prospects for the Company. This was not factually correct and indeed was misleading.

73. By a report dated 9 October 2004, the Company formally reported its unrealised losses on its options portfolio to CAOHC. However, it was not until 30 November 2004 that an announcement was made to the public of such losses.

74. The Company had various opportunities to do so when public announcements were made for instance when CAOHC sold part of its shareholding in the Company amounting to 15% of the Company (20 October 2004); or when its third quarter financial statements were announced (12 November 2004); or when CAOHC withdrew its support for the Company's intended acquisition of shares in the Singapore Petroleum Company (24 November 2004). On each occasion it failed to do so.

H. <u>The External Auditors</u>

75. In the Audit Committee Report for 2003[16], the External Auditors had stated that management had accounted appropriately for the speculative options that the

[16] This report was presented at the Audit Committee meeting on 18 February 2004 by the External Auditors.

Company had traded in 2003. It appears from this report that management had valued these options by amortising the premium income over the life of the options as a substitute for time value. In our view this was not an approach appropriate for valuing options and we therefore do not agree with this statement in the Audit Committee Report.

76. The External Auditors accepted that the Company had valued the options which they had reviewed as part of the audit for the financial year 2003 on the intrinsic value method, and that this was inappropriate[17]. However, they offered an explanation for the apparent contrary statement in the said report. They said that this approach, which they assert was arrived at after discussion with the Company[18], provided a reasonable surrogate for time value for short-dated options. They further said that as the Company sold mostly short-dated options in 2003, the approach could be applied for the audit for the financial year 2003, and its application did not result in a material error in the PBT for 2003. Accordingly, in their view the options had been appropriately accounted for by management. We do not accept these contentions for various reasons including the following:

    76.1 the Company sold a significant number of compound options (i.e. options with an extendible feature) that extended the tenure as well as increased the volume. As a result, these options could not properly be regarded as short-dated options; and

    76.2 we do not understand the valuation theory underpinning this assertion and have not found any commentary or authority to support it. Nor have we been provided with one.

77. The External Auditors have said that the Audit Committee was subsequently informed at its meeting on 18 February 2004 that the Company's MTM calculations had to be and had been adjusted and, after adjustment, they believed that no further adjustment to the Financial Statements for 2003 was required. However, notwithstanding this and the External Auditors' acceptance of the "*surrogate approach*", we do believe that that the Audit Committee ought to have been provided complete information on the issues surrounding management's valuation and accounting of the Company's options[19] because, it was relevant to alert the Audit Committee to:

    77.1 the possibility that the Company did not have the expertise to value options;

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[17] They informed us that they had told the Company that the appropriate method of valuation was to include both the time value and the intrinsic value of the options.

[18] The External Auditors said in their letter dated 7 March 2005 that they informed the Company that without adjustment, the MTM valuation for the options trades was unacceptable for financial statement purposes. After deliberation with the Company, the Company represented that it would value options on the basis stated by the External Auditors, and that for the purpose of determining the time value of the options that was to be included in the Financial Statements for 2003, the Company would use the time based amortisation of the options premium.

[19] We observe that we do not find this communication in the minutes of the Audit Committee meeting.

77.2 the possibility that the Company did not have a risk management environment to control the risk associated with speculative trading of options; and

77.3 the possibility (following from the preceding two points) that the Company did not have the expertise and skill sets to manage the risks associated with speculative trading of options.

78. It is significant that despite the discussion between the External Auditors on the inaccuracy of the valuation methodology that was applied by management in 2003, management continued to value options on an intrinsic basis in 2004.

79. We note that in the Audit Committee Report for 2003, it is stated that, *inter alia*:

79.1 the External Auditors were informed by Ms Ng and Mr Lim that the Company commenced speculative trading in options in the third quarter of 2003 and it *"ventured into this form of derivative trading to widen its trading activities."* ;

79.2 the Company was still developing standard operating procedures for options trading; and

79.3 this form of derivatives was being done on a limited basis.

80. In fact, our investigations reveal that:

80.1 speculative trading of options in fact commenced on 28 March 2003;

80.2 from the outstanding open options position set out in the Financial Statement for 2003, which the External Auditors reviewed, the Company was not carrying out speculative trading of options on a limited basis; and

80.3 the options that the Company had sold in 2003 included compound options.

81. It thus ought to have been apparent to the External Auditors that:

81.1 the Company had commenced trading in a new product (options), and had not put in place risk management procedures to control the risks associated with speculative trading of options and to make matters worse these options were compound options which carried higher risks;

81.2 the Company had undertaken a significant volume of speculative trading of options without putting in place these procedures; and

81.3 the Company had moved into a trading activity that carried with it significant risks which had yet to be controlled by an efficient and effective risk governance environment.

I. Corporate Governance

82. It is apparent from the Prospectus and the Annual Report for 2001 that the Company had been engaged in speculative trading of swaps and futures from at least 1999 and that this had continued in 2001[20].

83. Whereas the Independent Directors[21] accept that at all material times they were aware the Company was speculating in futures and swaps and from February 2004, they were also aware that it was speculating in options, the CAOHC Nominee Directors[22] contend that they were not aware of the Company's speculative trading of derivatives, including options, despite there being disclosure of the same in the Annual Reports or discussion at the Board and (in relation to Mr Li) Audit Committee meetings on this subject.

84. Mr Jia informed us that[23] CSRC prohibited state-owned enterprises from engaging in speculative trading of derivatives[24] and only permitted the use of futures for hedging against the risks that such corporations assumed in their business activities, provided that a licence was first procured from CSRC[25].

85. Mr Jia further informed us that in March 2002, following a perusal of the Company's Prospectus on the website of the Company, CSRC became aware that the Company was engaged in speculative trading in swaps and futures, and censured CAOSC for the Company's trading in derivatives without prior approval.

86. According to Mr Jia:

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[20] See Prospectus and pages 32 and 33 of the Annual Report 2001. See also pages 10 and 18 of the Annual Report 2001 which stated that a RMC had been set up to monitor and control the risks of physical and paper trading, and that a comprehensive RMM was being developed. The RMM was translated into Chinese and sent to CAOHC. See also pages 33 and 44 of the Annual Report 2001 which contain the statements that financial instruments undertaken by the Company *"for trading purposes are marked to market"*, and that the Company may *"take open positions in derivatives at the opportune time"* respectively.

[21] We refer to Mr Lee and Mr Tan here.

[22] We refer to Mr Jia, Mr Li and Ms Gu here.

[23] Our understanding of the matters referred to in paragraphs 84, 85 and 86 is gathered from our interviews with Mr Jia. This was also confirmed by some members of management and Mr Li. We have, however, not sighted the relevant PRC legislation, conducted interviews with officials from CSRC or obtained advice from PRC solicitors on this point.

[24] In a note dated 14 May 2005, Mr Li informed us as follows:

"As far as I know, by the end of 2004, there were only regulations stipulated for overseas futures business… the regulations only stipulate futures. It also excludes OTC trades… In effect, since CSRC governs based on the regulations, then their purview over matters officially would be over the issues pertaining to what is in the regulations, which is therefore futures and excludes OTC and also excludes other derivatives products. Clause 9 of the Administrative Method stipulates: Enterprises licensed to carry out overseas futures business may only engage themselves in hedging trading on overseas futures market. This rule further makes it clear that the regulations cover futures, and is confined to hedging. By mentioning expressly hedging, it is understood that no speculative trading is allowed. The regulation need not further specify that only hedging is allowed and that speculation is not allowed. Following from here, ***although the regulation disallows speculation on futures only, it is generally well understood from the reference to control over speculation and the direction that it should be hedging activities that are allowed, that we also understand that speculation in other derivatives products is not allowed either****."* (emphasis added)

[25] This licence carried with it a reporting requirement on the volume of derivatives that was transacted for hedging and the volume of physicals that was being hedged against.

86.1 after being censured by CSRC sometime in March 2002, the Company was then directed by CAOSC to submit a self-criticism report to CAOSC for onward transmission to CSRC. This was done in the course of the following few months;

86.2 at the same time, CSRC instructed the Company to cease its speculative derivatives trading, to restrict its derivatives trading to hedging and to apply for approval to trade in futures for hedging purposes;

86.3 the Board and Mr Jia then directed the Company to cease speculative trading of derivatives[26]; and

86.4 in or around October 2002, CAOHC filed an application to CSRC for a licence to do so. The licence was granted in March 2003. A sub-licence was subsequently granted to the Company by CAOHC through a letter dated 1 June 2003 for the Company to engage in futures trading for hedging purposes.

87. Mr Li also confirmed that he knew about the Company's derivatives trades from the Prospectus that was issued at the time of the listing and also that there had been criticism from the CSRC as a result of this. Mr Li further informed us that he became aware of the CSRC's prohibition on speculative trading when he became a member of the Board in 2003. In addition, Ms Gu had prepared and submitted the application to CSRC for the licence to use futures for hedging purposes.

88. Despite the gravity and significance of this incident with CSRC, the Company in fact continued speculative trading in derivatives in 2002, 2003 and 2004. This fact was openly disclosed in the Annual Reports[27] for 2002 and 2003 and in discussions that took place at Board and Audit Committee[28] meetings of the Company during this period. It should also be noted that at the Audit Committee meeting of 18 February 2004 and in Financial Statements for 2003 released (as part of the Annual Report 2003) in April 2004 the fact that the Company engaged in speculative trading of options was disclosed.

89. We have also not seen any documentary evidence that shows that the Independent Directors were ever informed of or consulted on the CSRC issue[29]. We would have expected an issue of this importance to have been raised and

[26] Mr Jia conceded that this direction was not in writing.

[27] Which incorporates the Financial Statements.

[28] The Audit Committee meetings were particularly pertinent where Mr Li was concerned given his position as a member of the Audit Committee. One such meeting was that of 18 February 2004 when the Audit Committee Report disclosing the commencement of options trading was tabled. Mr Li who was at that meeting must have known that the Company was engaged in speculative trading, and in the process had expanded its portfolio of derivatives. Despite this, Mr Li still did not disclose to the Independent Directors the issue with CSRC. Nor did he question management for the apparent broadening of the Company's speculative activities.

[29] We see no discussion on this subject in the Board or Audit Committee minutes of meeting in 2002. When asked, Mr Jia has stated that he was of the view that it was the responsibility of Mr Chen to convey information regarding the CSRC incident to the Independent Directors. We have great difficulty with this response as it ignores 2 facts. First, the importance of the role of the Independent Directors. Second, on Mr Jia's evidence, he directed the Company to comply with a prohibition that was imposed on CAOSC and the Company by CSRC. Whether the Company ought to have complied with the same ought to have been a decision for the entire Board to make.

discussed by the Audit Committee and the Board. In this regard, Mr Lee and Mr Tan, the local Independent Directors, have consistently maintained that they were not told by Mr Chen (and for that matter any of the other CAOHC Nominee Directors) that the Company was prohibited from engaging in speculative trading of derivatives as a consequence of a prohibition by CSRC and this was consistent with the other evidence we have seen.

90. Further, on at least 1 occasion when the opportunity was presented, Mr Li had not disclosed to CSRC the fact that speculative trading of derivatives was continuing in the Company.

91. In our view,

91.1 as at the beginning of 2004, the Directors (including the CAOHC Nominee Directors) knew or ought to have known that the Company continued to engaged in speculative trading of futures and swaps after the issue with CSRC in March 2002;

91.2 at no time were any effective steps imposed by the Board to stop the Company engaging in speculative trading in such derivatives despite the CSRC's prohibition;

91.3 the Independent Directors were not informed in March 2002 or thereafter about the issue with CSRC and in particular the censure for speculative trading;

91.4 at least from February 2004, Mr Lee, Mr Tan and Mr Li knew the Company was speculating in options and from April 2004 at the latest, when the Financial Statements for 2003 were finalised, the other CAOHC Nominee Directors at least had access to publicly available information that disclosed that the Company was engaged in the speculative trading of options;

91.5 the Independent Directors were not informed in March 2002 or thereafter about the issue with CSRC, or the censure for speculative trading or that CAOSC had been instructed by CSRC in March 2002 to stop speculative trading and to restrict derivatives trading activity to the use of futures for hedging. The Independent Directors were also not told of any instruction having been given by Mr Jia to the Company to stop speculative trading of derivatives. The failure to communicate a material fact, namely the CSRC censure, to the Independent Directors was a failure in corporate governance and may have undermined any efforts the Independent Directors, as members of the Audit Committee, could have made to address the situation. This was compounded by the efforts not to disclose the continued trading to the CSRC; and

91.6 there is no evidence to indicate that any of the directors (other than Mr Chen) were aware of the mounting losses or of the restructuring exercises that were being undertaken prior to October 2004.

92. It is clear that management did fail to make disclosure of certain facts and matters to the Board, and that Mr Chen, in particular, had the greatest responsibility in this regard, given his knowledge of the said facts and matters and his dual role as CEO and MD.

93. Notwithstanding this, we are of the view that there were serious failures of corporate governance on the part of the Board that contributed to the current predicament of the Company. In assessing these failures, the differences in the knowledge that the various groups of directors had become relevant.

94. We consider that the Audit Committee (including Mr Li) was aware at least from February 2004 that the Company was conducting speculative trading in options. Further, although in our view, the Audit Committee (save Mr Li) did not know about the CSRC censure or the prohibition on speculative derivatives trading, it is clear from the minutes of the meetings that it was aware of the fact that the PRC Government, and possibly CAOHC, had rules governing or controlling such trading. However, no steps were taken to establish exactly what the relevant rules and regulations were. Further, although concerns were repeatedly voiced about the increasing scale of speculative trades, no adequate steps were taken to establish the facts relating to this or to ensure that controls were in place to address the Audit Committee's concerns.

95. Further, we observe that the Audit Committee failed to:

95.1 identify and monitor as a significant business and financial risk the speculative trading of options. This is of particular gravity as the Company's activities in this area included the selling of a significant amount of exotic options and this carried potentially unlimited liability. There was no inquiry into the nature of this product nor was a financial and risk assessment carried out;

95.2 investigate why the approval procedure for new products stipulated in the RMM was not followed in relation to the commencement of options trading;

95.3 understand why the system of internal controls and risk management framework proved insufficient to preventing management from embarking on speculative trading of options;

95.4 ensure that there was an effective system of internal controls and risk management framework to identify, evaluate and manage the business risks from speculative trading of options after being told of such activity;

95.5 examine the IAD's audit plan for 2004 in relation to the speculative trading of options. In particular, attention should have been brought to bear on the adequacy of the scope of work in this area, and the level of cooperation that was being provided by management;

95.6 after the Audit Committee meeting on 18 February 2004, follow-up on the risk management procedures and controls that were stated as being developed in the Audit Committee Report for 2003;

95.7 follow-up on the volume of options that had been traded when considering the quarterly announcements for 2004;

95.8 request regular management reports and monitor periodically the Company's speculative derivatives positions, its financial exposure to such positions, and the MTM values of such positions; and

95.9 improve the expertise of the IAD in view of the growing complexity of the derivatives trading business of the Company with the introduction of speculative trading of options.

96. As noted above, it is clear that, at least by February 2004, the Audit Committee was aware that the Company had commenced speculating in options from 2003. Indeed, Mr Lee had been aware of this since January 2004. The failure of the Audit Committee to investigate how this had transpired without the relevant requirements of the RMM for the commencement of new businesses being followed was an especially significant failure.

97. In relation to Mr Li, as we have noted, he had at least the same knowledge or sources of information as the Independent Directors and the foregoing comments on the Audit Committee apply to him but with greater force given that he alone was aware of the CSRC prohibition and was involved in efforts to avoid disclosing the continued speculative trading to them.

98. As for the other CAOHC Nominee Directors, we conclude that as at January 2004, they knew or ought to have known of the fact that the Company was speculating in futures and swaps. Further they could have learnt of the fact that this extended to options from information that was publicly available[30]. In the circumstances, the fact that they were aware of the CSRC prohibition but did not disclose this to the Independent Directors is another corporate governance failure.

99. These Directors were aware of the risks that derivatives trading posed and also expressed concerns at the increasing volume of paper trades. However, their failure to take effective steps to enforce controls on such trading is yet another failure of governance.

100. In defence, some of the reasons sought to be relied upon by the CAOHC Nominee Directors include difficulties that they had with the language, the intricacies of derivatives and of financial statements and their lack of previous experience in being directors of a Singapore company. Even if one accepts that they had such difficulties[31], directors of a Singapore listed company must take

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[30] We are of the view that Mr Jia, in particular, had considerable opportunity to acquire such knowledge of the Company's speculative trading in options, given:

(a) his position and responsibility as Chairman of the Company at all material times; and
(b) Mr Li, who in our view had knowledge of the fact of options trading, had a direct reporting line to him in CAOHC

[31] We find it even more difficult to accept that such reasons avail to Mr Li, given his position and responsibility as Head of CAOHC's Assets and Finance Management Division.

responsibility to understand its business and carry out their duties as required of such directors.

J. Events of October and November 2004

101. Margin calls on the Company continued to escalate with the uptrend in oil prices in 2004. The increased risk assumed by the Company as a result of the options written under the January, June and September restructurings manifested itself when oil prices spiked in early October 2004. By then, the Company had utilised most of its available banking facilities and cash resources to satisfy these margin calls.

102. Faced with an acute cash and credit crunch, the matter was formally reported to CAOHC in early October. It would be another 7 weeks or so before these matters were disclosed to the Independent Directors, External Auditors, the Exchange and the investing public. In the meantime, while trading in the Company's shares continued, inaccurate public announcements were made by the Company.

103. On or about 9 October 2004, Mr Chen prepared a report to CAOHC, which was sent to the CAOHC Executive Committee on 10 October 2004. Mr Chen's report specifically indicated, *inter alia*, that:

    103.1 the Company had suffered significant losses due to the steep increase in oil prices as a result of which the Company could face liquidation if the situation was not properly managed;

    103.2 the losses were unrealised and based on current high oil prices, amounted to $180 million;

    103.3 the Company required $130 million to support margin calls but this could increase to $200 million if oil prices rose to $55/bbl, and that under certain scenarios, the losses could amount to $560 million;

    103.4 if the Company met the margin call payments in time, the unrealised losses could be reduced or even *"eliminated"* when oil prices came down;

    103.5 if the Company did not meet the margin call payments in time, counterparties might commence legal proceedings which could result ultimately in the liquidation of the Company;

    103.6 the Company was going to announce its financial results soon. According to Singapore practice, even unrealised losses had to be disclosed. If the Company made disclosure according to the true facts, this would have the same result, namely the liquidation of the Company; and

    103.7 if all the options positions had been closed-out on 7 October 2004, the realised losses would be $500 million and if closed-out on 8 October 2004, the realised losses would be $550 million.

    (translated from Chinese document)

104. The report then proposed the following solution:

104.1 that the Company and CAOHC sign an agreement transferring the options positions to CAOHC in a "back-to-back" arrangement so that the Company's accounts would not show a loss, and its results would therefore not be affected;

104.2 after taking over the positions, CAOHC could monitor the market and employ measures as appropriate in order to reduce the loss, possibly to zero; and

104.3 when circumstances necessitated the realisation of losses, in order to ensure that CAOHC did not have to bear the losses, it was suggested that CAOHC should sell part of its shares in the Company to strategic investors, while at the same time preserving CAOHC's position as the major shareholder.

(translated from Chinese document)

105. A further report by Mr Chen was sent to CAOHC on 11 October 2004[32]. The report stated, *inter alia*, that any disclosure of the Company's losses (realised or unrealised) would thwart any attempt to salvage the situation as the Company's share price would collapse and the Company would then face liquidation. Mr Chen hence urged CAOHC to avoid disclosure of the losses and to restrict discussion of the matter to the CAOHC Executive Committee and its Finance Department.

106. A crisis management team was immediately set up by CAOHC on 10 October 2004 to deal with the Company's problem. This crisis management team was headed by Mr Chen and included Mr Li, Ms Gu, Mr Zhang Zhicheng, Mr Yang and Mr Bian Hui.

107. Mr Jia informed us that in the period from 10 October to 28 November 2004, the CAOHC Executive Committee convened a total of 11 *"special meetings"* to seek ways to overcome the crisis.

108. It appears that during this period, various efforts were being considered or made by the Company and CAOHC, including efforts by CAOHC officials who were concurrently members of the Board of the Company[33], to try to rescue the Company. These efforts included pursuing a *"package solution"*[34] with potential

[32] In this report, Mr Chen stated that when the losses had stood at $30 million, he had chosen not to realise the losses in order to safeguard the Company's interest but that his assessment of the market had been wrong. He also stated that he had failed timeously to report these matters to the Chairman and other CAOHC leaders.

[33] Namely Mr Jia, Mr Li and Ms Gu. It will be recalled that Mr Jia was President of CAOHC and thus headed to CAOHC Executive Committee, while Mr Li and Ms Gu were members of the crisis management team.

[34] CAOHC informed us that from around 20 October 2004, CAOHC explored the possibility of rescuing the Company by way of a *"package solution"* which included trying to locate sources of funds and to procure the help of a *"strategic partner"* to raise further funds, take over the Company's options positions and/or obtain expertise to manage the Company's options positions and liabilities; and as part of this *"package solution"*, CAOHC also considered entering into a back-to-back agreement with the Company.

"strategic partners" in order to raise funds, take over the Company's options positions and/or obtain expertise to manage the Company's options positions and liabilities; preparations for the possibility that CAOHC might take over the Company's positions, to the extent of preparing a back-to-back agreement; making conditional representations to the Company's counterparties along the lines that CAOHC would provide financial support in respect of the Company's liabilities; the disposal of part of CAOHC's shareholding in the Company in order that the proceeds could be used to fund the Company's liabilities; and attempts to raise further funds through loans[35].

109. At least from 9 October 2004 to 27 November 2004, i.e. from the time there was formal disclosure by Mr Chen to the Chairman of the Company and other directors of the Company who were nominees of CAOHC[36], there was no disclosure to the Independent Directors, the External Auditors, the Exchange or the investing public of the Company's financial predicament.

110. The Company's 3Q 2004 results were due to be released in November 2004. Mr Lim was aware of the need to disclose the Company's losses in the 3Q 2004 results to be presented and approved by the Audit Committee.

111. However, Mr Lim took the position that the Audit Committee could be allowed to remain ignorant of the losses as long as a back-to-back agreement transferring the liabilities of such losses to CAOHC could be obtained. Mr Chen, in order to prevent Mr Lim from making such disclosure to the Audit Committee, procured what purported to be a back-to-back agreement executed by CAOHC and the Company and faxed this to Mr Lim. Mr Jia has categorically informed us that he did not execute this document and that CAOHC did not ever decide to authorise the execution of such an agreement. Mr Li and Ms Gu have concurred with Mr Jia's position. Mr Chen has also admitted that it was he who had placed Mr Jia's signature on this document.

112. Accordingly, on the 12 November 2004, the Audit Committee was not informed by Mr Lim of the losses, nor of the purported back-to-back agreement. The announcement of the Company's 3Q 2004 results made on that same day immediately after the Audit Committee meeting reported a net profit, instead of an actual loss[37] [38].

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[35] CAOHC has informed us that it has *"never relented in its efforts to come up with the rescue plan. Together with the Company, CAOHC explored the various available options, and was constantly finding means to raise the necessary funds for the Company, as seen from its placement of the Company's shares and its constant sourcing for potential investors. Even when it became evident that the funds required were too great, it was decided that restructuring of the Company's debts by way of a scheme of arrangement would be the most feasible option to ensure that the interest of the Company and its shareholders would be protected. Further, CAOHC continued to look for strategic partners and even managed to engage Temasek as a potential investor. All these rescue efforts clearly show CAOHC's strong determination and commitment in providing the Company with its full support during this entire time of crisis."*

We do not question the intentions of CAOHC in its efforts to rescue the Company. However, it is a fact that these efforts were made without any appropriate disclosures being made by the Company to the Independent Directors, the External Auditors, the Exchange or the investing public.

[36] See footnote 33 above.

[37] The 3Q 2004 results released by Mr Lim reflected profit after tax of S$8.8 million (for the 3Q 2004 itself) and S$41.7 million (year-to-date profits). The actual losses on the other version of the results prepared by Mr Lim were S$360 million (for the 3Q 2004) and S$327 million (year-to-date losses).

113. On the same day the Company issued a media release saying that the Company's prospects were *"still highly positive"*.

114. Following the release of the inaccurate 3Q 2004 results, no steps were taken by management or those directors of the Company, who were aware of the true position, in particular Mr Jia, Mr Li and Ms Gu, to rectify the situation.

115. On 28 November 2004, the Independent Directors were informed for the first time about the losses by Mr Li and were presented with a resolution to file an application under Section 210 of the Act for a meeting of creditors to be called to approve a Scheme of Arrangement to be proposed between the Company and its creditors, which they duly signed.

116. On 29 November 2004, the Company filed an application in the High Court under Section 210 of the Act.

117. The directors also requested the Exchange to suspend trading of the Company's shares and a public announcement was made on 30 November 2004 of the $550 million loss incurred by the Company, the scheme application and the circumstances surrounding the losses suffered by the Company.

118. The Company's options portfolio was completely closed-out at the end of December 2004.

119. To set the events of October and November 2004 in context, after Mr Chen submitted the report on the situation to CAOHC and the directors of the Company who were nominees of CAOHC[39] on 9 October 2004, the negative MTM value of the Company's options portfolio escalated from $367 million to $423 million (on or about 20 October 2004), to $443 million (on or about 15 November 2004), to $567 million (on or about 30 November 2004)(See Appendix 11). These figures do not include the cost of termination in respect of any remaining open positions at the relevant dates[40].

K. **Concluding Observations**

120. Based on the above, we are of the view that the following factors, individually and collectively, contributed to the losses that the Company suffered as a result of speculative options trading:

    120.1 a view of the trend of oil prices from 4Q 2003 which in the event proved incorrect;

    120.2 the desire not to record and disclose losses in 1Q 2004, 1H 2004 and 3Q 2004 that led to the assumption of imprudent and unwarranted risks

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[38] With regard to the announcement of the Company's 3Q 2004 results, no Board meeting was held to approve the results. It was explained to us that for the 1st and 3rd quarter results, the Board did not meet, and hence the results were approved by circulating resolution. Based on the records we have seen, the resolution approving this set of results had been signed by Mr Lee alone.

[39] See footnote 33 above.

[40] See paragraph 124 below.

under the restructurings in 2004 (in particular, the assumption of significant risks under the June and September restructurings);

120.3 the failure by the Company to value its options portfolio in accordance with industry standards;

120.4 consequently, the failure by the Company to appropriately recognise the MTM values of its options portfolio and report the same accurately in its Financial Statements and the quarterly and half yearly announcements from 2002 to 2004;

120.5 the absence of proper and stringent, and in some instances basic, risk management procedures and controls specifically for speculative options trading;

120.6 to the extent that there were risk management procedures and controls that could have applied to the options trades[41], management's readiness to override these; and

120.7 the failure on the part of the Audit Committee in particular, and the Board in general, to fulfil their respective duties in relation to risk management and controls applicable to the Company's speculative derivatives trading.

121. The Company's speculative derivatives trading experience before it ventured into speculative options trading was limited to swaps and futures. The Company entered into options trading without undertaking the sort of risk analysis that was contemplated in the RMM would be done before trading in a new product commenced.

122. Once the Company was facing potential and imminent losses on its options portfolio in January 2004, the significant risks that it assumed in the restructurings that followed proved to be its undoing as it eventually lost its financial capacity to meet margin calls in a rising market. The incorrect accounting and financial treatment, valuation methodology and consequent errors in financial disclosure by the Company of its options portfolio compounded the situation. By January 2004 when it faced the negative MTM value on its options portfolio the Company was already exceeding many of the limits (to the extent these were applicable to options) and it was incumbent upon the Company to have proceeded in accordance with procedures contemplated in the RMM, namely to bring itself within the limits. The strategy for any new trades patently should not have been influenced by the desire to avoid recording the same. The Company's strategy in fact resulted in a manifold increase in risk with each restructuring. This resulted in the exponential increase in the negative MTM value of the options portfolio which the Company faced with each upward movement in oil prices. The Company eventually found itself in a position where it was unable to cope with the mounting margin calls. The increasing risk that the Company took on with each of the restructurings ultimately led to its current financial predicament.

[41] See paragraph 65 above.

123. Further, throughout the period of at least 7 weeks from 9 October 2004 to 27 November 2004, CAOHC, through the crisis management team and the CAOHC Executive Committee, was trying to find ways to resolve the Company's problem. In the meantime, no disclosure was made, by the Company's management[42] or those directors who were aware of the Company's predicament[43], to the Independent Directors, the External Auditors, the Exchange or the investing public.

124. It is clear that by the time the options portfolio was completely closed-out at the end of December 2004, the realised loss was $550 million. This included the termination costs levied by the counterparties as the close-out of these positions was pursuant to the default by the Company[44].

125. This financial debacle could only happen because of the failure at every level of the Company. If anyone at any level had independently asked more questions, or delved a little deeper, or even sought to understand the position more fully, the situation might well have been averted.

[42] Including Mr Chen.

[43] See footnote 33 above.

[44] The Company had informed CAOHC on 9 October 2004 that the close-out value on 7 October 2004 would be $500 million and on 8 October 2004 would be $550 million. However, we are not aware of how the Company arrived at these values.