

## **Introduction**

The Securities and Futures Ordinance (**SFO**) which came into effect on 1 April 2003 establishes dual civil and criminal regimes under Parts XIII and XIV respectively in relation to all types of market misconduct. 'Market misconduct' includes 6 offences: insider dealing, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions and stock market manipulation. In addition, Part XIV creates 3 new criminal offences.

The new market misconduct provisions represent a considerable extension of the previous law on market manipulation and disclosure of false and misleading information concerning securities and futures. The following is intended as a brief overview of the principal provisions of the SFO as they relate to market misconduct (with the exception of insider dealing which is covered in a separate note) and the new Part XIV offences. The text in blue can be clicked through to view further information on a selected subject.

## **What Is Market Misconduct?**

Parts XIII and XIV create virtually identical civil and criminal provisions in respect of the following:

### **False Trading (Sections 274 and 295)**

False trading occurs when:

1. a person, in Hong Kong or elsewhere, does anything or causes anything to be done, with the intention that, or being reckless as to whether, it creates, or is likely to create, a false or misleading appearance -
  - a. of active trading in securities or futures contracts traded on an exchange or through an ATS in Hong Kong; or
  - b. with respect to the market for, or the price of, securities or futures contracts traded on an exchange or through an ATS in Hong Kong. Such conduct by a person in Hong Kong which has a similar effect on securities or futures traded on an overseas market may also amount to false trading.
2. a person, in Hong Kong or elsewhere, is involved, directly or indirectly, in one or more transactions (whether or not any of them is a dealing in securities or futures) with the intention that, or being reckless as to whether, they create or maintain, or are likely to create or maintain, an artificial price for securities or futures contracts traded on an exchange or through an ATS in Hong Kong.

Again, the same conduct but by a person in Hong Kong which has a similar effect on securities or futures traded on an overseas market may also constitute false trading.

It is not necessary for the transaction or transactions concerned to be in securities or futures. These provisions therefore prohibit a range of conduct that occurs off a market that affects prices on a securities or futures market, most importantly cross-market manipulation (i.e. conduct in one market which has a manipulative effect in another market) and cornering (i.e. monopolising or restricting supply of an asset so as to manipulate its price).

A person who engages in an on-market 'wash sale' or 'matched order' is presumed to have intended, or been reckless as to whether, his conduct creates or is likely to create a false or misleading appearance of active trading, the market for, or price of, the securities (S274(5) and S295(5)). He will have a defence if he can establish that the purposes for which he engaged in the transaction did not include the purpose of creating such a false or misleading appearance (S274(6) and S295(7)). The presumption applies only to 'on-market' wash sales and matched orders – that is they are recorded on the relevant exchange or ATS or have to be reported to the exchange or ATS operator under the rules governing the exchange or ATS. For off-market wash sales and matched orders, the prosecution will need to prove the mental element.

'Wash sales' are trades in which a person buys or sells securities without there being a change of beneficial ownership (Sections 274(5)(a) and 295(5)(a)).

A 'matched order' is where a person offers to sell or buy securities at a price that is substantially the same as the price at which he has made or proposes to make, or he knows an associate of his has made or proposes to make, an offer to buy or sell the same or substantially the same number of securities (Sections 274(5)(b) and (c) and 295(5)(b) and (c)).

Where the offence in question involves conduct in Hong Kong which affects securities or futures traded on an overseas market, the prosecution must prove that such conduct is also unlawful in the country in which the market is situated (Sections 282(3) and 306(3)). The same applies to price rigging and stock market manipulation where the conduct in question takes place in Hong Kong but affects securities or futures traded on an overseas market.

An 'associate' is defined to include a person's spouse or reputed spouse, brother, sister, parent, step-parent, natural or adopted child or step-child, any corporation of which a person is a director, any partner or employee of a person and in the case of a corporation, each of its directors and its related corporations and each director or employee of any of its related corporations.

### **Price Rigging (Sections 275 and 296)**

Price rigging occurs when a person in Hong Kong or elsewhere:

1. engages, directly or indirectly, in a wash sale of securities which has the effect of maintaining, increasing, reducing, stabilising, or causing fluctuations in, the price of securities traded on an exchange or through an ATS in Hong Kong; or
2. engages, directly or indirectly, in any fictitious or artificial transaction or device with the intention that, or being reckless as to whether, it has the effect of maintaining, increasing, reducing, stabilising, or causing fluctuations in, the

price of securities, or the price for dealings in futures contracts, that are traded on an exchange or through an ATS in Hong Kong.

The same conduct by a person in Hong Kong which affects securities (or, in the case of paragraph 2, securities or futures contracts) traded on an overseas market will also constitute price rigging if such conduct is unlawful in the country in which the relevant market is situated.

A person will have a defence in relation to 1 above (and also where the conduct is in Hong Kong and affects securities traded on an overseas market) if he can establish that the purposes for which the securities were sold or purchased did not include the purpose of creating a false or misleading appearance with respect to the price of securities (Sections 275(4) and 296(5)).

### **Stock Market Manipulation (Sections 278 and 299)**

These provisions relate only to transactions in securities.

Stock market manipulation occurs when, in Hong Kong or elsewhere, a person enters into or carries out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction:

- a. increase, or are likely to increase, the price of any securities traded on an exchange or through an ATS in Hong Kong, with the intention of inducing another to purchase or subscribe for, or to refrain from selling, securities of the corporation or those of a related corporation;
- b. reduce, or are likely to reduce, the price of any securities traded on an exchange or through an ATS in Hong Kong, with the intention of inducing another to sell, or to refrain from purchasing, securities of the corporation or those of a related corporation;
- c. maintain or stabilise, or are likely to maintain or stabilise, the price of any securities traded on an exchange or through an ATS in Hong Kong, with the intention of inducing another to sell, purchase or subscribe for, securities of the corporation or those of a related corporation, or to refrain from so doing.

The same conduct in Hong Kong which affects securities traded on an overseas market will also amount to stock market manipulation if the same conduct is unlawful in the country in which the relevant market is situated.

### **Disclosure Of Information About Prohibited Transactions (Sections 276 and 297)**

Disclosure of information about prohibited transactions occurs when a person discloses, circulates or disseminates, or authorises or is concerned in the disclosure, circulation or dissemination of, information to the effect that the price of securities of a corporation, or the price for dealings in futures contracts, that are traded on an exchange or through an ATS in Hong Kong, will be affected or is likely to be affected by a prohibited transaction (ie. any conduct or transaction which constitutes market misconduct or contravenes Part XIV) relating to either the corporation or a related corporation or futures contracts if he, or an associate of his:

- a. has entered into, directly or indirectly, the prohibited transaction; or
- b. has received, or expects to receive, directly or indirectly, a benefit as a result of the disclosure, circulation or dissemination of the information.

These provisions build upon the previous law in Section 135(5) of the SO and Section 62(2) of the CTO. Their aim is to prevent persons involved in market misconduct, their associates or those they have recruited for reward from spreading information about the effect that market misconduct is going to have on the price of a security or futures contract. Those involved in market misconduct may seek to increase their profits by spreading such rumours hoping that ordinary investors will be encouraged to buy or sell, so pushing the price of the securities or futures further in the direction that those involved in the market misconduct intend.

It is a defence if a person can establish that:

- a. the benefit which he or his associate received, or expected to receive, was not from a person involved in the prohibited transaction or an associate of his; or
- b. the benefit which he or his associate received, or expected to receive, was from a person involved in the prohibited transaction or an associate of his, but up to (and including) the time of the disclosure, circulation or dissemination of the information, he acted in good faith.

These defences are intended to cover persons such as journalists and research analysts who may innocently report market misconduct and its effect on prices and innocently receive a benefit for such conduct.

A 'related corporation' is defined as follows:

- a. 2 or more corporations are regarded as related corporations of each other if one of them is:-
  - i. the holding company of the other;
  - ii. a subsidiary of the other;
  - iii. a subsidiary of the holding company of the other;
- b. when an individual:
  - i. controls the composition of the board of directors of one or more corporations;
  - ii. controls more than half of the voting power at general meetings of one or more corporations; or
  - iii. holds more than half of the issued share capital (excluding any part which carries no right to participate beyond a specified amount on a distribution of either profits or capital) of one or more corporations,

each of the corporations referred to in paragraphs i to iii, and each of their subsidiaries, are regarded as related corporations of each other.

## **Disclosure Of False Or Misleading Information Inducing Transactions (Sections 277 and 298)**

Disclosure of false or misleading information inducing transactions occurs when, in Hong Kong or elsewhere, a person discloses, circulates or disseminates, or authorises 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 futures 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 stabilise the price of securities, or the price for dealing in futures contracts, in Hong Kong,

if:

- i. the information is false or misleading as to a material fact or through the omission of a material fact; and
- ii. the person knows that, or is reckless or, for civil market misconduct only<sup>1</sup>, negligent as to whether, the information is false or misleading as to a material fact or through the omission of a material fact.

Defences are available for those who unwittingly disseminate false or misleading information in the course of their business, which involves disseminating information received from others and who are not in a position to check the accuracy of that information. In summary these defences are for:

- a. persons operating a 'conduit' style business of issuing or reproducing information supplied by others, such as publishers and printers;
- b. persons whose business involves electronically providing access to third party information, where the information is wholly devised by another person, for example those operating internet websites providing access to third party information; and
- c. broadcasters of information devised wholly by another.

These defences may only be relied upon if the person did not know that the information was materially false or misleading at the time of disclosure. They are narrowly drafted and will only be available in very specific circumstances. In particular, they are only available where the information has been devised entirely by someone else and the defendant and his officers and employees did not in any way modify or exercise control over the information. In the case of paragraph b, it must also be made clear that those re-transmitting the information have not devised it, and do not take responsibility for or endorse its accuracy.

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<sup>1</sup>Under Section 298, negligence will not suffice to establish criminal liability.

These provisions have significant implications for issuers of securities (whether listed or unlisted) and their advisers. While it must be the case that the information is likely to have an effect (ie. induce a dealing in, or affect the price of, securities or futures contracts) in Hong Kong, the disclosure of information may occur anywhere. Further, it is not necessary for the information disclosed to in fact have such an effect. It is sufficient if the information is likely to have that effect. Given that negligence as to whether the information is materially false or misleading is sufficient to establish civil liability (and recklessness may establish criminal liability), these provisions are of considerable significance for roadshows, research analysts and the imparting of information to potential investors generally.

### **Scope Of Offences**

The new regime is far-reaching. In the case of the market manipulation offences (ie. false trading, price rigging and stock market manipulation) the offences cover both conduct in Hong Kong or elsewhere which affects securities (or futures) traded on an exchange or through an ATS in Hong Kong and conduct in Hong Kong which has the same effect on securities (or futures) traded on an overseas market. Where the conduct affects an overseas market, the prosecution must prove that the conduct is also unlawful in the country in which the market is situated.

### **Additional Offences**

These new offences created by Part XIV are not within the definition of 'market misconduct' and are therefore not liable to proceedings before the Market Misconduct Tribunal (**MMT**) and are instead subject to criminal proceedings only.

### **Use Of Fraudulent Or Deceptive Devices In Transactions In Securities, Futures Contracts Or Leveraged Foreign Exchange Trading (Section 300)**

This offence provides that a person shall not, directly or indirectly, in a transaction involving securities, futures contracts or leveraged foreign exchange trading:

- (a) employ any device, scheme or artifice with intent to defraud or deceive; or
- (b) engage in any act, practice or course of business which is fraudulent or deceptive, or would operate as a fraud or deception.

### **Disclosure Of False Or Misleading Information Inducing Others To Enter Leveraged Foreign Exchange Contracts (Section 301)**

A person shall not, in Hong Kong or elsewhere, disclose, circulate or disseminate, or authorise or be concerned in the disclosure, circulation or dissemination of, information that is likely to induce another person to enter into a leveraged foreign exchange contract in Hong Kong, if:

- a. the information is false or misleading as to a material fact or through the omission of a material fact; and
- b. the person knows that, or is reckless as to whether, the information is false or misleading as to a material fact or through the omission of a material fact.

This prohibits the same conduct in relation to leveraged foreign exchange contracts as is outlawed in respect of securities and futures transactions under Section 298. Section 301 also provides the same narrowly drafted defences as that section for those who passively disseminate information received from others such as printers, internet website operators and broadcasters.

### **Falsely Representing Dealings In Futures Contracts On Behalf Of Others (Section 302)**

A person shall not represent to another person that he has on behalf of the other person dealt in, or facilitated or arranged for any dealing in, a futures contract traded on an exchange or through an ATS in Hong Kong (or a contract or other instrument substantially resembling a futures contract in accordance with the rules of a futures market outside Hong Kong), if he has not in fact done so and he knows that, or is reckless as to whether, he has not done so.

## **Effects Of Market Misconduct**

### **The Market Misconduct Tribunal (MMT)**

Part XIII of the SFO extends the civil market misconduct regime to cover all types of market misconduct, not just insider dealing as was previously the case. The MMT, which replaces the IDT, is chaired by a judge assisted by two members and a presenting officer appointed by the Secretary for Justice conducts proceedings. Like the IDT it is inquisitorial and is entitled to direct that the SFC carry out further investigations and report its findings to the MMT. It differs from the IDT in that:

- i. the sanctions available to it are different from those available to the IDT; and
- ii. the role of the presenting officer has been clarified. Under the SFO the presenting officer is a lawyer whose role is to present evidence to the MMT. The intention is that he should be more like a prosecuting counsel, rather than a counsel assisting the tribunal as was the case with the IDT and that he should have more independence.

There are detailed provisions in the SFO governing the composition of and procedures to be followed by the MMT.

### **Proceedings of the MMT**

The Financial Secretary may under Section 252 institute proceedings before the MMT in respect of any suspected market misconduct following a report by the SFC or a referral from the Secretary for Justice by giving notice in writing to the MMT setting out the terms of reference for the proceedings.

The main purpose of proceedings is to determine:

- a. whether any market misconduct has taken place;
- b. the identity of every person involved in the market misconduct; and
- c. the amount of any profit gained or loss avoided as a result of the market misconduct.

The MMT may identify a person as having engaged in market misconduct if:

- a. he has perpetrated any market misconduct;
- b. the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or
- c. another person engaged in market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.

The MMT makes its findings on the civil standard of proof. It needs therefore to be satisfied that a person has engaged in market misconduct on the balance of probabilities (rather than beyond reasonable doubt which is the criminal standard of proof). However, like the IDT, the MMT has powers to receive any evidence, whether or not such evidence would be admissible in civil or criminal proceedings. It also has wide powers to compel the giving of evidence and to prevent the publication of information about the evidence the MMT receives. Significantly, a person is not excused from complying with a requirement of the MMT to give evidence on the ground that to do so might incriminate him (Section 253(4)) and such compelled self-incriminatory evidence may be considered by the MMT.

#### **Orders of the MMT**

At the end of any proceedings, the MMT may under Section 257(1) impose the following sanctions on any person found to have committed market misconduct:

- a. a disqualification order – that a person shall not, without the leave of the Court of First Instance, be or continue to be a director, liquidator, or receiver or manager of the property or business, of a listed corporation or any other specified corporation or in any way, whether directly or indirectly, be concerned or take part in the management of a listed corporation or other specified corporation for up to 5 years;
- b. a cold shoulder order – that a person shall not, without the leave of the Court of First Instance, in Hong Kong, directly or indirectly, deal in any securities, futures contract or leveraged foreign exchange contract, or an interest in any of them or a collective investment scheme for up to 5 years;
- c. a cease and desist order – that the person must not again engage in any specified form of market misconduct;
- d. a disgorgement order – that the person pay to the Government an amount up to the amount of any profit gained or loss avoided as a result of the market misconduct;
- e. Government costs order – that the person pay to the Government its costs and expenses in relation to the proceedings and any investigation;
- f. SFC costs order – that the person pay the SFC's costs and expenses in relation to any investigation; and
- g. disciplinary referral order – that any body which may take disciplinary action against the person as one of its members be recommended to take such action against him.



The ability of the IDT to impose high fines (which could be up to 3 times the amount of profit made or loss avoided as a result of insider dealing) has been abandoned in favour of a wider range of civil sanctions. In addition, a disgorgement order may, at the discretion of the MMT, be made subject to compound interest from the date of the occurrence of the market misconduct in question (Section 259). The SFC also has the ability to fine regulated persons (see 'Disciplinary Proceedings' below).

When making an order, the MMT may take account of any previous convictions in Hong Kong, any previous findings of market misconduct by the MMT and any previous findings of insider dealing under the S(ID)O (S257(2)).

Cold shoulder orders, cease and desist orders, SFC costs orders and disciplinary referral orders were introduced by the SFO. Failure to comply with a disqualification, cold shoulder or cease and desist order is a criminal offence under sub-sections 257(10) and 258(10) punishable by a maximum fine of \$1 million and/or up to 2 years' imprisonment.

In addition, Sections 253(2) and 254(6) prescribe a penalty of a maximum fine of \$1 million and a maximum of 2 years' imprisonment for failure to comply with various requirements of the MMT or disrupting its proceedings. The conduct referred to in those sections and in Sections 257(10) and 258(10) is also liable to be punished as contempt under Section 261.

### **Appeals**

Any person who is dissatisfied with a finding or determination of the MMT may appeal to the Court of Appeal but only in respect of a point of law or, with the leave of the Court of Appeal, on a question of fact (Section 267).

### **Criminal Liability**

All forms of market misconduct (including insider dealing, previously subject to civil proceedings only) and the new Part XIV offences are liable to prosecution as a criminal offence under Part XIV SFO.

### **Penalties**

The maximum criminal sanctions were increased by the SFO to a maximum of 10 years' imprisonment and fines of up to \$10 million. Previously the maximum penalties under the different ordinances were inconsistent. The court may also impose disqualification, cold shoulder and disciplinary referral orders. Failure to comply with a disqualification or cold shoulder order is an offence liable to a maximum fine of \$1 million and up to 2 years' imprisonment.

### **No double jeopardy**

A person will not be subject to the 'double jeopardy' of both civil proceedings under Part XIII and criminal proceedings under Part XIV for the same conduct. The SFO provides that a person who has been subject to criminal proceedings under Part XIV may not be subject to MMT proceedings if those proceedings are still pending or if no further criminal prosecution could be brought against that person again under Part XIV in respect of the same conduct and vice versa (Sections 283 and 307).

The decision as to whether to take civil or criminal proceedings in relation to suspected market misconduct is made by the Secretary for Justice. The SFC may also institute summary criminal proceedings before a magistrate for less serious market misconduct offences, although the Secretary for Justice is able to intervene in the SFC's conduct of any such proceedings. The decision whether to take criminal or civil proceedings is made in accordance with the Department of Justice's Prosecution Policy which provides two criteria for the institution of criminal proceedings: that there is sufficient evidence for a criminal prosecution and that a criminal prosecution is in the public interest. If these tests are not met, suspected market misconduct will be dealt with through civil proceedings before the MMT.

### **Civil Liability – Private right of action**

The SFO creates a private right of civil action in favour of anyone who has suffered financial loss as a result of market misconduct or any offence under Part XIV to seek damages from the person who committed the market misconduct or Part XIV offence. The perpetrator is liable to pay damages, unless it is fair, just and reasonable that he should not (Sections 281 and 305).

A person will be taken to have committed market misconduct if:

- a. he has perpetrated any market misconduct;
- b. the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or
- c. any other person committed market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.

It is not necessary for there to have been a finding of market misconduct by the MMT or a criminal conviction under Part XIV before bringing civil proceedings. Findings of the MMT are however admissible in the civil proceedings as prima facie evidence that the market misconduct took place or that a person engaged in market misconduct. Further a criminal conviction constitutes conclusive evidence that the person committed the offence. The courts are able to impose injunctions in addition to or in substitution for damages.

### **Transactions not void or voidable**

Sections 280 and 304 provide, as under the previous legislation, that a transaction is not void or voidable by reason only that it constitutes market misconduct or contravenes Part XIV.

### **Liability Of Officers Of A Corporation**

The SFO imposes a duty on all officers of a corporation to take reasonable measures to prevent a corporation from perpetrating market misconduct. The definition of 'officers' is wide and includes 'any person occupying the position of director' and 'persons involved in management' of the corporation.

### **Duty of Officers**

Section 279 of the SFO imposes a duty on all officers of a corporation to take reasonable measures to ensure that proper safeguards exist to prevent the corporation from acting in a way which would result in the corporation perpetrating any market misconduct. This is an extension of the duty contained in the S(ID)O. Under the SFO the duty applies to all forms of market misconduct and not just insider dealing.

The definition of an 'officer of a corporation' is also broader than under the S(ID)O. It includes a director (including a shadow director and any person occupying the position of a director), manager or secretary of, or any other person involved in the management of, the corporation. The last category (ie. any other person involved in management) was not included in the S(ID)O definition and could, in principle, catch supervisors and anyone else with management responsibilities.

Under Section 258, where a corporation has been identified as having been engaged in market misconduct and the market misconduct is directly or indirectly attributable to a breach by any person as an officer of the corporation of the duty imposed on him by Section 279, the MMT may make one or more of the orders detailed above in respect of that person even if that person has not been identified as having engaged in market misconduct himself. However, a breach of the Section 279 duty will not expose a person to civil suits by third parties unless he has been identified as having engaged in market misconduct.

### **Civil Liability**

As described above, the SFO clearly provides that anyone who suffers financial loss as a result of market misconduct or a Part XIV offence has a right of civil action to seek compensation. As noted above, an officer of a corporation which perpetrated market misconduct is taken to have committed market misconduct himself, if the corporation perpetrated the misconduct with his consent or connivance.

### **Criminal Liability**

Under Section 390 of the SFO, where it is proved that an offence committed under Part XIV was aided, abetted, counselled, procured or induced by, or committed with the consent or connivance of, or attributable to the recklessness of, any officer of the corporation, or any person purporting to act in any such capacity, that person, as well as the corporation, is guilty of the offence and liable to be punished accordingly.

### **Disciplinary Proceedings**

Under Part IX of the SFO, any regulated person who is guilty of misconduct or who, in the opinion of the SFC, is not a fit and proper person to be or to remain the same type of regulated person, is subject to a widened range of disciplinary procedures. 'Misconduct' is defined to include any contravention of the SFO or of the terms of any licence issued or registration made under it. The SFC may revoke or suspend a person's licence in respect of all or any part of the regulated activities for which he is licensed. In addition, or alternatively, the SFC may impose a fine not exceeding the greater of \$10 million or 3 times the amount of the profit gained or loss avoided by the regulated person as a result of his misconduct, or such other conduct which led to the SFC's opinion that he is not fit and proper. The SFC may also impose prohibition orders preventing an offending person from, among other

things, applying to be registered or licensed under the SFO. Approvals granted to 'responsible officers' may also be suspended or revoked. Persons covered by these provisions include corporations licensed under the SFO, their responsible officers and persons involved in their management. Significantly, authorised financial institutions (now required to be registered with the SFC if carrying out certain regulated activities), their executive officers, persons involved in the management of their regulated business and individuals named in their register as carrying out a regulated activity, are also now subject to the SFC's disciplinary regime.

## **Miscellaneous**

### **Safe Harbour Rules**

To allow for future business practices, the SFO allows the SFC to make rules creating defences to the market misconduct civil and criminal provisions, subject to prior consultation with the Financial Secretary (Sections 282 and 306). A safe harbour has been established for price stabilisation in public offerings over \$100 million under the Securities and Futures (Price Stabilising) Rules.

This note is intended as a summary of the provisions of the SFO as they relate to market misconduct. Specific legal advice should be sought in relation to any particular situation.

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