Fairer markets: the SFO and more effective market misconduct laws[1]

Passed by the Legislative Council in March this year, the SFO will become law shortly in early 2003. The dual civil and criminal regime for insider dealing, market manipulation, spreading false or misleading information about securities or futures and other abuses, collectively called "market misconduct" is one of the SFO's most important features. The regime's goal is to better protect Hong Kong's markets and investors from serious crime and misconduct which can undermine investor confidence and cause severe financial losses.

This article will explain the key features of the new regime, how it will operate in practice and the reasoning behind some decisions made in its development.

Existing regime

Insider dealing is a civil wrong defined in the *Securities (Insider Dealing) Ordinance* (**S(ID)O**). Under the S(ID)O, the Insider Dealing Tribunal (**IDT**) inquires into cases of suspected insider dealing referred to it by the Financial Secretary on a civil basis, using civil procedures, a high civil standard of proof approaching the criminal standard and without being bound by the civil or criminal laws of evidence. The IDT is comprised of a judge and two other members who are not public officers, chosen for their experience in the markets or relevant professions. The IDT is inquisitorial and has powers to compel evidence, including compelling witnesses to give testimony on oath or affirmation. The IDT may, during an inquiry, direct that the SFC further investigate and give the information it obtains to the IDT. At the end of an inquiry, the IDT makes a report of its findings and may punish anyone it finds guilty of insider dealing with a variety of orders:

- to prohibit a person from being involved in the management of any named corporations for up to 5 years (**disqualification orders**)
- to pay the Government an amount equal to the profit made or loss avoided as a result of the insider dealing (**disgorgement orders**) and
- to pay the Government a penalty of an amount up to three times the profit made or loss avoided as a result of the insider dealing (**fining orders**).

In addition, if the IDT identifies a corporation as an insider dealer, and an officer of that corporation has failed to take reasonable measures to ensure proper safeguards are in place to prevent the corporation from insider dealing and the insider dealing is directly or indirectly attributable to that failure, the IDT may impose disqualification and fining orders on that officer. Lastly, the IDT may order that an insider dealer, or an officer of a corporation who has breached their duty to take reasonable steps to prevent the corporation of which they are an officer from insider dealing, pay to the Government an amount equal to the costs of the inquiry, costs incidental to the inquiry and any investigation for the purposes of the inquiry (**Government costs orders**).

[1] *This article was prepared by Eugène Goyne of the Enforcement Division of the SFC*

To date, the IDT has conducted 14 inquiries in which it has identified 27 people as insider dealers and ordered them to pay to the Government over $208 million in total or on average, about $8 million per person.

On the other hand, all other forms of market misconduct are crimes under sections 135-139 of the *Securities Ordinance* (**SO**) and sections 62-65 of the *Commodities Trading Ordinance* (**CTO**). The offences cover:

- false trading and markets (section 135 SO and section 62 CTO)
- restrictions on fixing prices for securities (section 137 SO) and
- false or misleading statements about securities or futures (section 138 SO and section 64 CTO).

Despite some recent successes with false trading and markets prosecutions, these offences are limited and have proven inadequate in effectively dealing with all the forms of conduct that are prejudicial to the interests of the investing public, in particular, some forms of market manipulation and false or misleading information about securities and futures.

Further, the beyond reasonable doubt criminal standard of proof and restrictive criminal evidence laws, which are not conducive to prosecuting conduct which is mainly proven with documentary evidence, have inhibited successful criminal prosecutions for more complex instances of market manipulation which the SFC's investigations have revealed. To date, there have only been 15 market manipulation prosecutions, brought against 19 people, of which 13 cases have been successful, leading to the conviction of 16 people. Other than the recent Gay Giano convictions, the vast majority of these were summary prosecutions in the Magistrates' Court for relatively straightforward instances of market manipulation. More complex market manipulation has never been prosecuted.

No prosecution has ever been brought for false or misleading information about securities or futures.

Even if a prosecution is successful, the maximum penalties available are inconsistent. Under the SO, there are a $50,000 fine and/or 2 years' imprisonment and, under the CTO, a $1,000,000 fine and/or 7 years' imprisonment. The difference in the maximum penalties for the same crimes involving securities and futures is inconsistent. Further, the maximum penalties under the SO are derisory and do not adequately punish or deter what can amount to a very serious crime which may result in millions of dollars of profit. To date, only 2 people have been gaoled following prosecutions under section 135 of the SO with sentences of 4 and 8 months each, which were recently upheld on appeal. 3 others have received suspended sentences or community service orders. The average fine imposed has been only about $39,000. Even though, encouragingly, the number of convictions and the likelihood of custodial or suspended sentences has increased recently, the overall results are disappointing.

The relative success of the civil system for dealing with insider dealing stands in stark contrast to the limited success of the purely criminal system for dealing with other forms of market misconduct. The greater success of the IDT can be attributed to:

- the fact that it is not bound by the civil or criminal laws of evidence and may consider any logical evidence it considers relevant, in particular, its ability to consider compelled self-incriminating testimony
- its use of a standard of proof below the criminal standard
- its ability to direct further investigation and to consider the resulting evidence and
- its ability to impose a range of strong penalties.

While the SO and CTO criminal offences were intended to effectively deter and punish market misconduct, other than insider dealing, there is considerable room for improvement.

Original proposal

Consequently, in his March 1999 Budget speech, the then Financial Secretary proposed the establishment of a tribunal to inquire into and punish all forms of market misconduct, to be modelled on the IDT and to be called the Market Misconduct Tribunal (**MMT**).

In July 1999, a consultation paper proposed that the MMT would have jurisdiction to inquire into and punish all the forms of market misconduct with similar orders to those available to the IDT except that, in substitution for a fine of up to three times the profit or loss made as a result of the market misconduct, the MMT would be able to fine up to $10 million or three times the profit made or loss avoided, whichever was the higher. The alternative of a fine not based on profit or loss was to enable fines to be imposed in cases where no profit was made or loss avoided or the profit or loss was incalculable.

Human rights constraints

In the course of developing this proposal, advice was received that law developing before the European Court of Human Rights (**ECHR**) under the *European Convention for the Protection of Human Rights and Fundamental Freedoms* (**European Convention**) suggested that fining orders could, in certain cases, be "criminal" for human rights purposes. The *Bill of Rights Ordinance* and the *Basic Law*, through its incorporation into Hong Kong law of the International Covenant on Civil and Political Rights (**ICCPR**), contain protections similar to those under the European Convention.[1] The Government has been advised that, while the matter is

[1] Articles 11(1) and (2)(g) Bill of Rights and article 39 Basic Law, incorporating into Hong Kong law articles 14.2-14.7 of the ICCPR. In *Murray v United Kingdom* (1996) 22 EHRR 29, the ECHR held that, even though not specifically mentioned in article 6 of the European Convention, the right to remain silent under questioning and the privilege against self-incrimination are generally recognised international standards which lie at the heart of the article.

not clear cut, there is a serious probability that the Hong Kong courts will consider the European law persuasive and that the courts would hold the high fines proposed as an MMT sanction "criminal" for human rights purposes.

The consequence of high fines being held to be "criminal" for human rights purposes would be that, if high fines were to be kept, the MMT would have to adopt a criminal standard of proof and compelled self-incriminating statements would no longer be admissible. The other alternative would be for the MMT to keep the existing procedural features of the IDT with a high civil standard of proof and compelled self-incriminating evidence admissible, but abandon high fines.

Either option would have been a compromise on the initial proposal for market misconduct.

The success of the IDT could be viewed as having been primarily due to its ability to consider compelled self-incriminating statements gathered during SFC investigations and to adopt a standard of proof below the criminal. To keep high fines would have made the MMT little or no more effective than the existing purely criminal regime for market misconduct other than insider dealing. It would not have better protected investors or Hong Kong's markets.

Modified proposal

In light of this advice, while the original imperatives behind the establishment of the MMT remained, it was decided that the prudent way forward was to abandon high fines and design a new regime of effective civil sanctions in substitution. To this end, it was proposed that the MMT be given the power to impose several new civil sanctions such as "cold shoulder" and "cease and desist" orders. In addition, orders to disgorge profits made or loss avoided through market misconduct would be subject to compound interest. These new penalties were designed to be as credible sanctions as possible, given the limits in the relevant human rights laws.

Nevertheless, the abandonment of high fines as a sanction obviously reduced the deterrent effect of the proposed regime compared with the existing insider dealing regime. To bolster the deterrent and punishment effect of the proposed civil regime, two new measures were proposed.

First, a criminal regime would be retained. It is acknowledged that all the difficulties of criminal prosecution for market misconduct remain. However, sanctions such as high fines and imprisonment have a strong deterrent and punitive effect. Even if it is difficult to secure a criminal conviction, the fear that such penalties may be imposed carries a strong deterrent effect. To ensure that this is the case, the maximum criminal sanctions have been increased to 10 years' imprisonment and/or fines of $10 million from the present unsatisfactory and inconsistent penalties.

As the SFC's experience to date has shown, there will be some cases where sufficient evidence exists and the public interest favours a criminal prosecution. Therefore, while it is unlikely that criminal prosecutions on indictment will be routine, it should

not be thought that the criminal regime will be superfluous. It was logically consistent for the SFO to extend the criminal regime to insider dealing.

Secondly, the SFO will make it procedurally easier for those who suffer pecuniary loss as a result of market misconduct to bring a civil action. While civil actions are mainly to compensate those who suffer loss, they also deter, as a person who commits market misconduct will also face the often substantial cost of compensating those who suffer pecuniary loss as a result. The SFO will make the findings of the MMT or a criminal court in relation to market misconduct admissible evidence in a civil suit. This will make it easier to bring a civil action for market misconduct, increasing the likelihood that a person found guilty will have to pay substantial damages and so increase the regime' s deterrent effect.

More effective market misconduct laws

The existing insider dealing laws have largely proved effective. So, the SFO will largely re-enact them. Nevertheless, the past 12 years' experience has exposed some loopholes.

The existing criminal offences in sections 135-139 of the SO and sections 62-65 of the CTO governing forms of market manipulation and disclosure of false or misleading information concerning securities and futures are quite limited and do not effectively outlaw all the conduct which they should.

These offences were originally drawn from 1970s Australian securities and futures laws. In the past 20 years, Australia has updated its laws on market manipulation and the disclosure of false or misleading information about securities or futures. The more modern Australian provisions[2] distilled much more detailed US provisions found in US statutes, regulations made by the US Securities and Exchange Commission (**SEC**) and US federal case law. The Australian provisions largely covered the same conduct as the US provisions but were more easily understandable and accessible as they were relatively self-contained. A body of jurisprudence has built up around the Australian provisions that has made them relatively predictable.

Neither the Australian provisions nor the US ones on which they are based have outlawed legitimate market transactions such as index arbitrage, program trading and hedging. So, it is safe to assert that such practices will continue to be legal in Hong Kong under the SFO.

It was considered that the Australian provisions would provide a useful model from which Hong Kong could draw effective and predictable provisions to outlaw various forms of market manipulation and false or misleading information concerning securities or futures contracts.

[2] Australia has since reformed its market misconduct laws that formed the model for the SFO provisions with the *Financial Sector Reform Act 2001* which commenced in March 2002. The provisions remain largely the same as those which formed the basis for the SFO provisions.

Comprehensive rights of civil action

Section 140 of the SO gives a person who has suffered pecuniary loss as a result of buying or selling securities at a price affected by conduct in breach of sections 135-139 of the SO a right of civil action against the person who has breached the relevant provision. There is no equivalent provision in the CTO for similar conduct in relation to futures contracts or in the S(ID)O for insider dealing. Those who suffer pecuniary loss as a result of conduct in breach of sections 62-64 of the CTO or insider dealing must presently rely on a cause of action that might arise at common law.

This lack of consistency has no sound policy justification. It is considered that a person who suffers pecuniary loss as a result of any form of market misconduct should have a clear right to take civil action to be compensated for their loss. To this end, the SFO will give those who suffer pecuniary loss as a result of market misconduct a clear right of civil action to seek compensation.[3] An affected person will be able to bring an action whether the loss arises from having entered into a transaction or dealing at a price affected by the market misconduct or otherwise.[4] A limiting factor exists in that damages will only be payable if it is fair, just and reasonable in the circumstances.[5] We are advised that this reflects the prevailing Hong Kong and UK authority on when a duty of care will be implied at common law. Experience overseas suggests that courts when faced with such a statutory right of action sensibly tend to import the limiting factors from tort law, including breach of duty, causation, remoteness, measure of damages and so on.

The SFO will also make taking such action procedurally easier to strengthen the deterrent effect of such actions, in particular by making MMT findings prima facie evidence of the occurrence of market misconduct or that a person has engaged in market misconduct.[6]

The courts will be able to impose injunctions in addition to or in substitution for damages.[7]

Flexible laws to adapt to changing markets

The line between legitimate and illegitimate conduct in the securities and futures markets may be very fine. Further, business practices in those markets change rapidly with commercial innovation, competition and technological change. It is difficult, when drafting a statute intended to last many years, to anticipate all the business practices which will evolve in the future. Some of these business practices may pose little or no threat to investors' interests and may even benefit investors but may infringe the laws designed to protect them. Given that it is difficult to draft statutory provisions flexible enough to anticipate all the conduct which should be legitimised while still outlawing all the conduct which is illegitimate, it is useful to give some

[3] Sections 281 and 305
[4] Sections 281 and 305
[5] Section s281(2) and 305(2)
[6] Sections 281(7)-(9) and 305(6)-(8).
[7] Sections 281(6) and 305(5)

flexibility to modify the law relatively quickly to adapt to changing business and market conditions.

It is not uncommon for securities and futures regulators to be given the power to modify the laws they administer, including laws creating criminal offences, by delegated legislation they make themselves. For example, the US SEC and Commodity Futures Trading Commission (**CFTC**) both have extensive powers to modify the laws they administer through rules they make.

To allow for more flexible market misconduct laws, the SFO will give the SFC a general power to create defences to the market misconduct provisions under Parts XIII and XIV through rules the SFC will make itself.[8] To provide a check and balance on the SFC's power to create defences to provisions the legislature has deemed crimes and civil offences, the SFC will only be able to make such rules following public consultation and consultation with the Financial Secretary. As delegated legislation, such rules will be subject to scrutiny and possible disallowance by the Legislative Council.

To date, the SFC proposes to create a defence for price stabilisation in public offerings over HK$100m. Consultation has already been conducted and draft final Securities and Futures (Price Stabilising) Rules are awaiting commencement of the SFO to take effect.

Market Misconduct Tribunal and the dual regime

The MMT's composition, procedures and powers will largely emulate those of the existing IDT, with three major differences:

- the MMT's jurisdiction will be broadened to cover all forms of market misconduct and not just insider dealing
- the sanctions available to the MMT will differ from those available to the IDT owing to human rights concerns and
- the role of the Presenting Officer, presently the counsel assisting the IDT will be made clearer.

The Financial Secretary will institute proceedings before the MMT either following a report of suspected market misconduct by the SFC or following a referral from the Secretary for Justice.[9] The scope for referral of suspected market misconduct by the Secretary for Justice to the Financial Secretary arises from the proposed creation of dual civil and criminal regimes for market misconduct.

Reports of suspected market misconduct will arise following an SFC investigation. At the conclusion of an investigation, the SFC will produce a report.[10] The SFC will have the power to refer such a report to the Financial Secretary to consider the institution of civil proceedings before the MMT or to the Secretary for Justice to

[8] Sections 282 and 306
[9] Sections 252(1), (8) and (9)
[10] Section 183(5).

consider the institution of criminal proceedings.[11] The SFC will also have the capacity to institute in its own name summary criminal proceedings before a Magistrate for less serious criminal market misconduct offences.[12] Consistent with her role in relation to criminal proceedings under the *Basic Law*, the Secretary for Justice will be able to intervene in the SFC's conduct of such summary criminal proceedings.[13] To date, this has never happened.

The decision as to whether to take civil or criminal proceedings in relation to suspected market misconduct will be made by the Secretary for Justice in accordance with the Department of Justice's Prosecution Policy – Guidance for Government Counsel. When the SFC decides to summarily prosecute less serious market misconduct before a Magistrate, it will also use the policy.

Under the policy, there are two considerations 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. Other jurisdictions with dual civil and criminal regimes for the same conduct such as the United States, the United Kingdom and Australia make decisions as to whether to deal civilly or criminally with that conduct the same way.

An SFC report to either the Financial Secretary or the Secretary for Justice will contain the SFC's observations on the sufficiency of evidence in the matter, the SFC's view of the seriousness of the matter and its regulatory impact and the SFC's recommendation as to whether it considers the matter will be better dealt with civilly or criminally. This recommendation will be merely that, a recommendation, and the Secretary for Justice will have the ultimate decision on what type of proceedings will be taken as only suspected market misconduct ruled out as unsuitable for criminal proceedings will be considered for civil proceedings.

If the SFC will have referred suspected market misconduct to the Secretary for Justice with a recommendation that she consider instituting criminal proceedings, she should have a means to refer the matter to the Financial Secretary for referral to the MMT for civil proceedings if she were to decide that the criterion for criminal prosecutions are not met.[14] Similarly, the Financial Secretary will have the power to refer suspected market misconduct to the Secretary for Justice to consider the institution of criminal proceedings if he were to disagree with an initial report of suspected market misconduct to him by the SFC with an SFC recommendation that he consider starting civil proceedings before the MMT.[15] In practice, the Department of Justice will advise both the Secretary for Justice on the institution of criminal proceedings and the Financial Secretary on the institution of civil proceedings before the MMT.

The Secretary for Justice will appoint a lawyer to be a Presenting Office whose role will be to present evidence to the MMT, including evidence that the MMT asks him or her to present, to enable the MMT to reach an informed decision on whether and

[11] Section 378(2)(*i*)(i) and (ii)
[12] Section 388
[13] Section 388(3)
[14] Section 252(9)
[15] Section 252(10)

what type of market misconduct has been committed.[16] The intention is that the Presenting Officer will be more like a prosecuting counsel and less like a counsel assisting the Tribunal, to remove the apparent lack of clarity as to the role of the counsel assisting the IDT at present in insider dealing inquiries and give the Presenting Officer more independence.

At the end of proceedings, the MMT will be able to impose the following sanctions on those it identifies as having engaged in market misconduct:

- disqualification orders
- disgorgement orders
- Government costs orders

like the existing IDT orders and, in addition,

- an order that the person must not, without the leave of the Court of First Instance, in Hong Kong directly or indirectly in any way trade in financial products which the SFC regulates (**cold shoulder orders**)
- an order that the person must not engage in any specified form of market misconduct again (**cease and desist orders**)
- an order that the person pay to the SFC an amount the MMT considers appropriate for the SFC's reasonable expenses in relation, or incidental, to any investigation of his conduct or affairs before the MMT proceedings or after (**SFC costs orders**) and
- an order that any body which may take disciplinary action against the person as one of its members be recommended to take disciplinary action against him or her (**disciplinary referral orders**).[17]

SFC costs orders are a logical extension of the existing IDT power to order an insider dealer pay the Government's inquiry and investigatory costs and the power of a court to order a person convicted of a crime following an SFC criminal investigation to pay to the SFC the SFC's investigatory costs.[18] Cold shoulder orders, cease and desist orders and disciplinary referral orders are all new orders selected for their credibility as sanctions and compatibility with human rights law.

Cold shoulder orders are modelled on orders that the Takeovers and Mergers Panel may impose under rule 12.2(e) of the Introduction to the Hong Kong Codes on Takeovers and Mergers and Share Repurchases and has imposed on those who breach those Codes or a ruling made under those Codes. They amount to a prohibition on dealing in Hong Kong in financial products regulated by the SFC and it might be thought are a fitting punishment for those found to have engaged in market misconduct.

Cease and desist orders are modelled on orders that the US SEC may impose in administrative proceedings for breach of the US securities laws. A person subject to an SEC cease and desist order must not continue to breach identified US securities

[16] Sections 251(4) and (5) and Schedule 9 section 21
[17] Section 257
[18] Section 33(15)(a) *Securities and Futures Commission Ordinance* (**SFCO**)

laws or breach such laws again. Breach of an SEC cease and desist order is punishable as a criminal offence or through contempt proceedings. Breach of any MMT order, including a cease and desist order, will be a crime.[19]

Disgorgement orders the MMT imposes will, at the MMT's discretion, be subject to compound interest at the rate applicable to judgement debts under section 49 of the High Court Ordinance from the date of the market misconduct.[20]

It is intended that these orders will effectively strip those who engage in market misconduct of their gain, remove them from participation in corporate management and the financial markets and recompense the authorities, and, indirectly, the public, for the costs of proceedings against them through a range of administrative measures. These orders are compatible with the relevant human rights laws and it is believed will effectively protect the public and markets from those who might engage in market misconduct. The protective, deterrent and compensatory effects of these orders will be bolstered by facilitating private civil suits and, if there is sufficient evidence and the public interest warrants it, the possibility of criminal punishment.

Owing to the dual civil and criminal regimes under Parts XIII and XIV respectively, a person may be civilly and criminally liable for the same conduct. To avoid a person being subject to the "double jeopardy" of both civil proceedings before the MMT under Part XIII and criminal prosecution under Part XIV for the same conduct, the SFO clearly provides that a person who has been subject to criminal proceedings under Part XIV may not be subject to MMT proceedings if those criminal proceedings are still pending or no further criminal proceedings could be brought against that person again under Part XIV in relation to the same conduct and vice versa.[21] The SFC reserves the right to take disciplinary action against a person found guilty of market misconduct, but will take into account the need to do so in light of the circumstances, in particular, the proportionality of penalties imposed and likely to be imposed with the seriousness of the conduct concerned.

Insider dealing

Division 4 of Part XIII and Division 2 of Part XIV contain civil and criminal provisions outlawing insider dealing.[22] The insider dealing provisions are based on the existing law and repeat the substance of the existing insider dealing provisions with some rewording. The most significant change is that insider dealing will also become a crime for the first time in Hong Kong under Part XIV.

The other major changes to the insider dealing provisions have occurred through changes to the supporting definitions. Those changes are:

- the insider dealing provisions will in future apply to dealing not only in securities that are issued and listed, but also issued and unlisted securities which, at the time of the insider dealing, it is reasonably foreseeable would be

[19] Section 257(10) and 258(10)
[20] Section 259
[21] Sections 283 and 307
[22] Sections 270-273 and sections 291-294

listed and are subsequently in fact listed and also unissued and unlisted securities which, at the time of the insider dealing, it is reasonably foreseeable would be issued and listed and which subsequently in fact are issued and listed.[23] This is to overcome a flaw in the existing insider dealing provisions which was identified in a previous IDT report. This means that insider dealing in the "grey market" (ie trading in rights prior to issue) will be covered. However, as insider dealing can still only occur in relation to a *listed corporation*,[24] insider dealing in an IPO grey market is not covered, as the corporation is not listed at that time. (It should be noted that the market manipulation provisions do arguably apply to such trading to the degree they affect post listing prices and trading.)

- the insider dealing provisions will in future clearly apply to inside information not only about the relevant corporation but also information about a shareholder or officer of the corporation or about the listed securities of the corporation or their derivatives.[25] Information about the identities of a corporation's shareholders or officers may have a significant bearing on the value of the corporation's securities as it may imply changes of ownership and corporate policy. Similarly, information about rights attaching to listed securities and derivatives over those securities may have a significant impact on the value of those securities and derivatives. These changes are perhaps most accurately seen as a clarification of the existing law rather than an extension.

- lastly, a person who holds more than 5% of the voting capital of a corporation will be regarded as a substantial shareholder for the purposes of the insider dealing provisions consistent with the changes to the regime for disclosure of interests in the capital of a listed corporation in Part XV.[26] This will have an effect on who is deemed to be "connected" with a corporation for the purpose of the insider dealing provisions ie the "insiders".

The defences to the insider dealing provisions will largely reproduce existing law.[27] However, the provisions are somewhat differently worded and their layout altered slightly to make them clearer. There are three significant changes.

A new defence for "market information" will be added for those who trade solely with the inside information about their own trading intentions and those who facilitate such trading.[28] For example, a person building up a stake in a company that they intend to make a takeover offer for and a merchant bank assisting in buying shares on the person's behalf and, in some senses, hedging the transaction. At present a person who deals with the "inside" information about their own trading activities is technically insider dealing even though technically this would inhibit some basic and unobjectionable transactions, such as a substantial shareholder increasing or reducing their stake in a company. The Hong Kong authorities have never taken action against such conduct and do not intend to. But, having an explicit defence is useful for market certainty. The defence is based on paragraphs 3 and 4 of Sch 1 of the UK

[23] Section 245(2) and 285(2) definitions of "listed securities"
[24] Sections 270 and 291 and section 245(2) and 285(2) definitions of "listed" and "listed corporation".
[25] Section 245(2) and 285(2) definitions of "relevant information"
[26] Sections 247(3) and 287(3)
[27] Sections 271-3 and 292-4
[28] Sections 271(8) and (10) and 292(8) and (10)

Criminal Justice Act 1993, the UK's criminal insider dealing laws, with minor changes to fit it within the wording of the SFO.

The second change will be that, for a person who enters into an off-market transaction that amounts to insider dealing with another person who knows or has reasonable cause that their counterparty had inside information to have a defence, they will now have to prove that the transaction was entered into directly on a principal-to-principal basis.[29] The defence is only justified when the parties to the transaction in question are dealing off-market in circumstances where they are assumed to be relatively equally sophisticated and where they are relatively familiar with one another or at least able to make inquiries of one another, so that neither party is at a serious information disadvantage.

Lastly, at present, it is a defence to insider dealing if a person enters into a transaction that amounts to insider dealing with another person, but not as a person who has counselled or procured that other person, and the other person knows or ought reasonably know that the insider dealer is an insider to the corporation. The defence operates on the assumption that people who transact with someone they know or should know is a company insider, which should only be able to occur in an off-market transaction, should be on notice that the other party may be insider dealing and so make adequate inquiries with the insider before dealing with them and maybe negotiate terms as to the disclosure of inside information. The SFO will re-enact this defence.[30] In addition, a new defence is added to protect a person who counsels or procures a person who has a defence in that precise same set of circumstances from liability.[31] It is simply a logical extension of the existing defence and would, for example, protect a merchant bank who introduced a prospective purchaser to a substantial shareholder of a listed corporation who the bank thought might want to tender to divest their shareholding and advised the shareholder on the sale.

Forms of market manipulation

Sections 274-5 and 278 in Part XIII and sections 295-6 and 299 in Part XIV will create a new range of more effective provisions to deal with forms of market manipulation.

As has been stated, the existing criminal offences governing forms of market manipulation are too limited in scope to effectively deter and punish conduct prejudicial to Hong Kong's markets and investors, are inconsistent and are punishable by inconsistent and sometimes inadequate maximum penalties. The new provisions are modelled on Australian laws which have proven to be effective, balanced and predictable. Some of these provisions are evolutions of the existing Hong Kong offences that also had their origins in Australian law some twenty to thirty years ago.

The new provisions will create identical civil and criminal provisions outlawing:

[29] Sections 271(5) and 292(5)
[30] Section 271(6) and 292(6)
[31] Sections 271(7) and 292(7)

- false trading in securities and futures contracts[32]
- price rigging in securities and futures contracts[33] and
- stock market manipulation[34] (securities only).

False trading

The false trading provisions are an evolution of the existing law in section 135 of the SO and section 62 of the CTO and are based very closely on former sections 998, 1260 and 1259 of the Australian *Corporations Act* (**ACA**) which, in turn, were modelled on US law. In effect, the proposed false trading provisions will outlaw four different types of conduct.

The first category of false trading outlaws a person, in Hong Kong or elsewhere, doing anything or causing anything to be done, with the intention that, or being reckless as to whether, it has or is likely to have the effect of creating a false or misleading appearance of active trading in or with respect to the market for or price of securities or futures traded on a recognised market or through an authorised automated trading system (**ATS**).[35] The first category also outlaws similar conduct but by a person in Hong Kong whose conduct affects securities or futures contracts traded on a relevant overseas market.[36] The provisions are based on former sections 998(1) and 1260(1) of the ACA (section 1041B(1) of the ACA has now replaced these sections with some modifications) which, in turn, are based on sections 9(a)(2) and 10(b) of the US *Securities Exchange Act* (**SEA**).

The approach of outlawing manipulative conduct whether in Hong Kong or overseas which affects securities or futures traded on an exchange or ATS in Hong Kong and conduct by a person in Hong Kong which affects foreign exchanges is adopted throughout the SFO market manipulation provisions. It is intended to better protect Hong Kong investors and markets and enable Hong Kong to play its part in outlawing international market misconduct which affects increasingly globalised markets. The US laws and most of the Australian market misconduct laws have extra-territorial effect. The new UK laws adopt a similar approach. There is a growing international consensus that such laws are necessary to better regulate globalising markets. Hong Kong as a significant international financial centre and responsible developed economy must play its part in combating globalised financial markets crime and misconduct. These laws will help. The SFC has expressly felt the need for such laws in several important matters in the past and would have used them if they were available at the time.

To prevent this approach from resulting in the outlawing of conduct in Hong Kong that has an affect on securities or futures traded on a market outside Hong Kong when that conduct would not be illegal in the place outside Hong Kong, the prosecution must prove that the conduct is also unlawful in that place.[37]

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[32] Sections 274 and 295
[33] Sections 275 and 296
[34] Sections 278 and 299
[35] Sections 274(1) and 295(1)
[36] Sections 274(2) and 295(2)
[37] Sections 282(3) and 306(3)

During consultation on the SFO, views were sought on whether a similar approach should be taken with insider dealing. But the issue attracted little public comment. It may be considered in the future.

The second category of false trading outlaws a person, in Hong Kong or elsewhere, being involved, directly or indirectly, in one or more transactions with the intention that, or being reckless as to whether, the transaction or transactions has or have or are likely to have the effect of creating an artificial price, or maintaining at a level that is artificial a price, for securities or futures traded on a relevant recognised market or an authorised ATS.[38] Again the provisions also outlaw the same conduct but by a person in Hong Kong which affects securities or futures traded on a relevant overseas market.[39]

Concerns were expressed by some during consultation suggesting that the term "artificial" was uncertain and would outlaw legitimate market practices like arbitrage, hedging and program trading. The experience in Australia with the ACA provisions suggest this is not so. The UK FSA' s Code of Market Conduct for market abuse, their equivalent to market misconduct, also uses the term artificial in connection with market manipulation.[40] The term is also regularly used in US market manipulation cases.[41] We take the term to mean a price not set by the natural forces of supply and demand unadulterated by manipulation.

The transaction or transactions concerned need not be in securities or futures so these provisions outlaw a range of conduct that can occur off a market that will affect prices on a securities or futures market, most importantly cross-market manipulation and cornering. Cross-market manipulation involves conduct in one market which has a manipulative effect in another market. For example, conducting activities on a stock market to achieve a manipulative effect on the futures market or vice versa. Cornering is conduct that involves monopolising or restricting supply of an asset so as to manipulate its price. For example, commodity futures may be manipulated by cornering the supply of the underlying commodity: with copper futures, this could be done by taking control of delivery of copper to copper warehouses and so manipulating the price of copper futures. The provisions are based on former section 1259 of the ACA (section 1041A(1) of the ACA has now replaced this section with minor changes).

The third and fourth category of false trading will outlaw "wash sales" and "matched orders", respectively:

- "wash sales" are trades in which a person buys or sells securities without there being a change of beneficial ownership in the transaction. The SFO defines a transaction as involving no change in beneficial ownership if a person who had

[38] Sections 274(3) and 295(3)
[39] Sections 274(4) and 295(4)
[40] MAR 1.5.8
[41] For example, *Mobil Corp v Marathon Oil Co* 669 F 2d 355 at 374, *Ernst & Ernst v Hochfelder* 425 US 185 (1976), *Santa Fe Industries Inc v Green* 430 US 462 at 476-7 (1977), *Crane Company v Westinghouse Air Brake Company* 419 F2d 787 (2d Cir, 1969) at 794, *Chris-Craft Industries Inc v Piper Aircraft Corp* 480 F 2d 341 (2d Cir) and *Trane Co v O' Connor Securities* 561 F Supp 301 (SDNY 1983)

a beneficial interest in the securities before the transaction, or an associate of theirs, has a beneficial interest in the securities after the transaction. That is a person basically sells securities to, or buys them from, themselves.[42]

- "matched orders" are situations in which a person offers to sell 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 substantially the same number of securities and vice versa.[43]

The prosecution will only have to prove that a person has engaged in wash sales or matched orders and will not have to prove a mental element. A person who has engaged in wash sales or matched orders will have a defence if they prove, on the balance of probabilities, that none of the purposes for which they engaged in the wash sale or matched orders was to create a false or misleading appearance with respect to active trading in securities or with respect to the market or price for them.[44] These provisions are based on former sections 998(5) and (6) of the ACA (which have been replaced by section 1041B(2) with minor changes) which are in turn based on sections 9(a)(1)(A), (B) and (C) and 10(b) of the US SEA.

The onus of proving an innocent mental element is imposed on the defendant in wash sales and matched orders because they are usually blatantly manipulative conduct which cries out for explanation. The mental element with which a person engages in market manipulation is rarely directly evidenced and usually must be inferred from circumstantial evidence including the nature of their trading. This is much harder to prove in a court or tribunal than to establish on a common sense basis. When the circumstances of a person's trading is so blatantly manipulative, the person who has engaged in such activity is the person best placed to explain if they engaged in that behaviour for only legitimate reasons. They will only have to do this on the balance of probabilities. It is felt that, it is reasonable, in these limited circumstances, to require the defendant to explain the reasons for their behaviour.

Wash sales and matched orders are only deemed to be unlawful if they occur on-market. That is they are recorded on the relevant market or ATS or have to be reported to the market or ATS operator under the rules governing that market or ATS.[45] Otherwise, the prosecution will have to prove the mental element.

Price rigging

The SFO will outlaw price rigging, which covers two types of conduct:

- the first is where a person in Hong Kong or elsewhere engages 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 a relevant recognised

[42] Sections 274(5)(a) and 295(5)(a)
[43] Sections 274(5)(b) and (c) and 295(5)(b) and (c)
[44] Sections 274(6) and 295(7)
[45] Sections 274(7) and 295(8)

market or through an authorised ATS.[46] Again the defendant will have to prove that their purposes were innocent.[47]

- the other is where a person in Hong Kong or elsewhere engages 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 futures traded on a relevant recognised market or through an authorised ATS.[48]

The same conduct by a person in Hong Kong which affects securities or futures contracts traded on a relevant overseas market will also be outlawed.[49] The provisions are based on former sections 998(3) and (8) and 1260(2) of the ACA (section 1041C(1) of the ACA has replaced these provisions with some changes).

Stock market manipulation

The SFO will also outlaw stock market manipulation which concerns securities only. Stock market manipulation occurs if a person, in Hong Kong or elsewhere, engages directly or indirectly in two or more transactions in securities of a corporation that by themselves or in conjunction with other transactions:

- increase or are likely to increase the price of any securities traded on a relevant recognised market or through an authorised ATS with the intention of inducing another person to buy or subscribe for, or to refrain from selling, securities issued by that corporation or a related corporation
- reduce or a likely to reduce the price of any securities traded on a relevant recognised market or through an authorised ATS with the intention of inducing another person to sell, or refrain from buying, securities issued by that corporation or a related corporation or
- maintain or stabilise or are likely to maintain or stabilise the price of securities traded on a relevant recognised market or through an authorised ATS with the intention of inducing another person to sell, buy or subscribe for, or to refrain from selling, buying or subscribing for, securities issued by that corporation or a related corporation.[50]

The SFO also outlaws the same conduct by a person in Hong Kong which affects securities or futures contracts traded on a relevant overseas market in the same manner.[51] These provisions are closely based on former section 997 of the ACA, which in turn is closely based on section 9(a)(2) of the US SEA.

Some expressed concerns in consultation that the stock market manipulation provisions would criminalise the trading of an investor who knew that a large purchase or sale by them would have a price effect. The law draws a clear distinction between knowledge and intention. In particular, the provisions require explicit

[46] Sections 275(1)(a) and 296(1)(a)
[47] Sections 275(4) and 296(5)
[48] Sections 275(1)(b) and 296(1)(b)
[49] Sections 275(2) and 296(2)
[50] Sections 278(1) and 299(1)
[51] Sections 278(2) and 299(2)

evidence of an intention to induce others to sell, purchase, subscribe or hold, as the case may be. We think the fears clearly unwarranted.[52]

Disclosure of false or misleading information about securities or futures

The SFO will outlaw the disclosure of false or misleading information about securities or futures that is likely to induce investment decisions or have a material price effect.[53]

The price of securities and futures is a reflection of information about their underlying value. As securities and futures are intangible items the value of which derives from a number of complex factors, it is difficult for an investor to easily verify for themselves the accuracy of information about the factors from which their underlying value is derived. For this reason, false or misleading information about securities or futures which is important enough to affect their price or induce investment decisions in relation to them can be very damaging to investors and markets. As information is disseminated so quickly and widely with new communication technologies false or misleading information can quickly harm a large number of investors. For this reason it is considered that the SFO must include firm measures to guard against the dissemination of false or misleading information.

The provisions will outlaw a person, in Hong Kong or elsewhere, from disclosing, circulating or disseminating, or authorising or being concerned in the disclosure, circulation or dissemination of information that is likely to induce the sale, purchase or subscription of securities or dealing in futures in Hong Kong or likely to affect the price of securities or futures in Hong Kong if:

- the information is false or misleading in a material fact or through the omission of a material fact and
- the person knows, or is reckless or, *for civil market misconduct only*, negligent as to whether, the information is false or misleading in a material fact or through the omission of a material fact.[54]

The provisions are based on former sections 999 and 1261 of the ACA (section 1041E of the ACA replaces these sections) and can be seen as evolutions of the existing Hong Kong law in sections 138 and 64 of the CTO.

The civil provision adopts a negligence mental element because it is considered that, owing to the damaging nature of false or misleading information, a high standard needs to be adopted so that those involved in the dissemination of information take precautionary steps to ensure that information disseminated is true and not misleading. As the information must be materially false or misleading and likely to induce investment decisions or have a price effect, trivial mistakes will not be caught. The civil penalties available to the MMT are believed to be a proportionate penalty for negligent conduct.

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[52] See the US case of *Trane* cited above in n 40.
[53] Sections 277 and 298
[54] Sections 277(1) and 298(1)

Defences will be available for whose who may passively disseminate false or misleading information owing to the nature, or an aspect, of their business, which involves disseminating information from others and who are not in a position to check the accuracy of that information, including:

- a person who operates a "conduit" style business of issuing or reproducing information given to him by others where the information was devised by another person typically a customer and the person did not select, add to, modify or exercise control over its contents, that information was issued or reproduced in the ordinary course of the person's business and at the time of issuing or reproducing the information the person did not know the information was materially false or misleading. This defence is intended for printers, publishers and the like.[55]

- a person who operates a business the normal conduct of which involves electronically allowing access to third party information which the person did not devise, select, modify, add to or exercise control over if the person did not know at the time of granting access to the third party information that it was materially false or misleading or did know and could not reasonably have stopped access to that information and before granting access to that information warned that they did not devise the information and neither take responsibility for it nor endorse its accuracy. This defence is intended for those who operate internet websites that provide access to third party information. Many online brokers for instance provide access to many third party financial information services to increase the "stickiness" of their website, ie its ability to attract and keep the attention of browsers.[56]

- a person who is a broadcaster who broadcasts live information in the ordinary course of his business being information that he did not devise or select, modify, add to or exercise control over and which he broadcast in accordance with the terms of his broadcasting licence or any relevant code of practice or guidelines issued under the relevant Hong Kong laws and at the time of the broadcast did not know the information was materially false or misleading or did know but could not reasonably be expected to stop the broadcast.[57]

Disclosure of information about prohibited transactions

The SFO will outlaw a person disclosing, circulating or disseminating or authorising or being concerned in the disclosure, circulation or dissemination of information that the price of the securities of a corporation or futures will be affected, or is likely to be affected because of a transaction in breach of the market misconduct provisions which relates to the securities of that corporation or a related corporation or futures (respectively) if he, or an associate of his, has:

- directly or indirectly entered into the prohibited transaction or

[55] Sections 277(2) and 298(3)
[56] Sections 277(3) and 298(4)
[57] Sections 277(4) and 298(5)

- has received or expects to receive a benefit as a result of the disclosure, circulation or dissemination.[58]

These provisions are an evolution of the exiting law in section 135(5) of the SO and section 62(2) of the CTO and are based on former sections 1001 and 1263 of the ACA (section 1041D of the ACA replaces these sections with minor changes) which in turn are based on sections 9(a)(3) and (5) of the US SEA.

The purpose of the provisions is to stop a person who is involved in market misconduct or their associates or those they have recruited for reward from spreading information that the price of a security or futures contract is going to be affected by market misconduct. Such conduct is a not uncommon accompaniment to some forms of market misconduct. Those engaging in market misconduct may hope to increase their profits by spreading rumours that the price of a security or futures is going to be affected by the market misconduct. Their intention will be to influence ordinary investors to buy or sell the securities or futures concerned as the ordinary investors will hope they themselves will profit from their knowledge of the likely price effect of the market misconduct which will further push the price of the securities or futures concerned in the direction that those engaging in the market misconduct originally intended.

The provisions depart from the Australian provisions on which they are based in that defences are added for those who spread the information about a prohibited transaction for reward. The defences are that the benefit does not come from a person who was involved in the prohibited transaction or an associate of such a person or the reward was from such a person but the person spreading the information acted in good faith. The defences are intended to cover journalists, research analysts and the like who innocently report the market misconduct and its likely price effect and who may innocently receive a benefit for such conduct. If their employer or other party giving them the benefit is the party who has engaged in market misconduct or an associate of such a party but the person spreading information about the market misconduct has acted in good faith (eg, they work for an investment bank which has engaged in market manipulation but are honestly and in good faith reporting the effect of the market manipulation to clients in a research report on the other side of an effective Chinese wall), they should also have the benefit of the defence.

Duty to act to prevent market misconduct

The SFO will impose a duty on an officer of a corporation to take all reasonable measures to ensure that proper safeguards exist to prevent the corporation of which they are an officer from acting in any way which would result in the corporation engaging in market misconduct.[59] This duty is derived from existing insider dealing law[60] which imposes a similar duty on officers of corporations but only in relation to insider dealing. The MMT will be able to impose sanctions on any person who is an officer of a corporation which the MMT identifies as having engaged in market misconduct if the corporation's market misconduct were directly or indirectly

[58] Sections 276(1) and 297(1)
[59] Section 279
[60] Section 13 S(ID)O

attributable to the a breach by that person of the duty imposed on them, even if they have not been identified as having engaged in market misconduct.[61] This builds on a provision of the existing insider dealing laws[62] in that the range of sanctions that can be imposed is broader. But, significantly, a mere breach of the duty to act to prevent market misconduct, without being identified as having engaged in market misconduct, will not expose a person to civil suits by third parties under the SFO.[63]

The duty is very significant as it applies to officers of any corporation, including listed corporations and licensed corporations. It will thus have far reaching implications which both listed corporations and intermediaries should carefully consider. For example, a listed corporation and it's licensed advisers would be required to take reasonable steps to develop, implement and monitor systems to ensure that false or misleading information was not issued in a listing rules announcement. A licensed corporation would be expected to take similar measures and might also be expected to take reasonable steps to monitor their clients' trading for market misconduct (eg inquiring into suspicious trading and refusing to act if the response was not adequate).

[61] Section 258
[62] Section 24 S(ID)O
[63] Sections 281(1) and (3)