TOPIC 7 - OVERVIEW

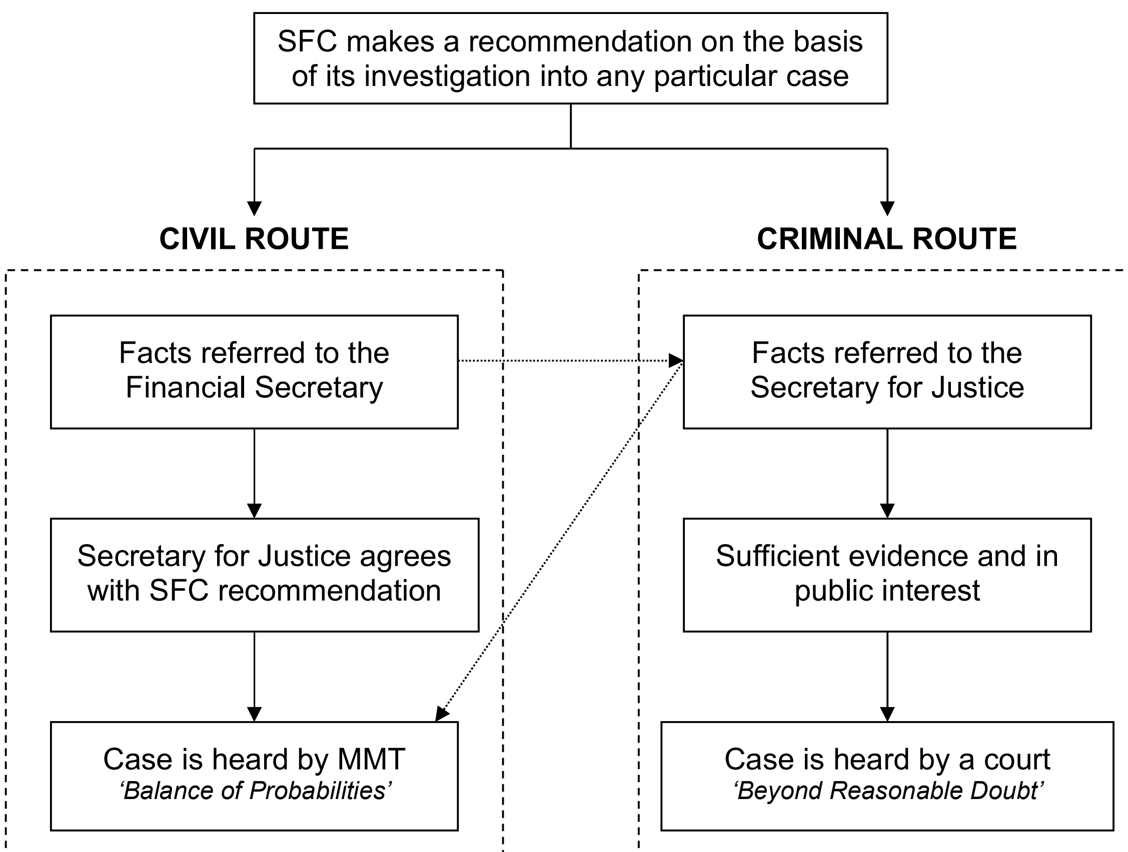
1. REGULATION OF MARKET MISCONDUCT

- The SFO (Part XIII) defines six types of **market misconduct**:

> - Insider dealing
> - False trading
> - Price rigging
> - Stock market manipulation
> - Disclosure of information about prohibited transactions
> - Disclosure of false or misleading information inducing transactions

- Legal proceedings against the accused can be **criminal** in the courts or **civil** under the Market Misconduct Tribunal (MMT), but not both (no "double jeopardy")

Criminal or Civil?



- The SFC has the power to prosecute minor cases summarily in a magistrate's court

2. MARKET MISCONDUCT

2.1. Insider Dealing

2.1.1 Insider Dealing Definitions

Insider dealing is trading in securities while in possession of material non-public information obtained, directly or indirectly, in breach of a fiduciary duty or relationship of trust and confidence

Dealing

- A person dealing in Hong Kong listed securities of a corporation or its related corporation or their derivatives where the person:
  - Is **connected with the listed corporation** and knowingly has **inside information** in relation to the listed corporation; or
  - Is contemplating making a **take-over offer** for the listed corporation, which is known to the person as inside information in relation to the listed corporation
  - Has received such information which he knows is inside information directly or indirectly **from a person known to be connected** with the listed corporation

Tipping-off

- A person **connected** with a listed corporation disclosing **inside information** or **knowledge of a take-over offer** to another person knowing that the other person will make use of that information for dealing/counseling/procuring:

Inside Information

- Specific information in relation to a corporation:
  - Which is **not generally known** to persons who deal in its listed securities; but
  - If such information was known to them, it would be likely to **affect the security price** (ie price sensitive information)

Connected Persons

- A person connected with the corporation includes:
  - Directors/employees/substantial shareholders (at least 5% of shares)
  - Professionals who have a business relationship with the corporation (eg auditors)
  - Connected person of another corporation and the relevant information relates to transactions between the two corporations

2.1.2 Defenses Against a Charge of Insider Dealing

- There a number of possible defences per the SFO, including:
  - **Chinese wall** – an institution has both relevant information and trades the relevant securities, but the persons trading are not those possessing the relevant information
  - The purpose of the insider dealing was **not for the purpose of making a profit** or avoiding a loss
  - The dealing was a market contract
  - Dealing where the other party to the dealing knows or should know **the person dealing is a connected person**
  - **Exercising an existing right**, where the right was acquired prior to becoming aware of the relevant information

2.2 False Trading

- Occurs in relation to securities and futures contracts when:
  - A person intentionally or recklessly creates a false or misleading appearance of active trading or the market or the price
  - A person is involved in transactions, intentionally or recklessly, which create an artificial price or maintains a price at an artificial level
- A person is presumed to have engaged in false trading if he enters into **wash trades** or **matched orders**:
  - **Wash trade**: any transaction involving a sale and purchase of securities without a change in beneficial ownership
  - **Matched order**: an offer to sell (or buy) securities that is matched by an actual or proposed offer to buy (or sell) the same securities
- Defence can be that acts were not for the purpose of creating a false market

2.3 Price Rigging

- Price rigging is a type false trading and focuses on unacceptable forms of price fixing
- Price rigging takes place when a person:
  - enters into a **wash trade** which has the effect of maintaining, increasing, reducing, stabilizing or causing **fluctuations in the price of securities**; or
  - enters into, or carries out, **a fictitious or artificial transaction** or device, intentionally or recklessly, which has the effect of maintaining, increasing, reducing, stabilizing or causing **fluctuations in the price of securities or future contracts**

Note: False trading and price rigging only apply to transactions entered on-exchange or via an authorized automated trading service – they do not apply to off-market transactions

2.4 Stock Market Manipulation

- Stock market manipulation occurs when a person wishes to influence the investment decisions of other persons by:
  - Entering into two or more transactions which have the effect of increasing/reducing/maintaining/stabilizing the price of securities

- False trading, price rigging and stock market manipulation, as defined in the SFO, cover transactions carried out:
  - In Hong Kong, or elsewhere, in respect of instruments traded on a recognized stock market or on an ATS
  - In Hong Kong, in respect of instruments traded on an overseas market

2.5 Disclosure of Information about Prohibited Transactions

- If someone:
  - who is **party to a prohibited transaction**, or has received a benefit from such an act
  - **discloses, circulates or disseminates information** about the transaction, and its effect on prices of securities or futures contracts
  - he will have engaged in market misconduct
- An **acceptable defence** is if the person can show that he **acted in good faith** or did not receive a benefit from the party to the market misconduct

2.6 Disclosure of False or Misleading Information Inducing Transactions (Rumour Mill)

- If someone:
  - Makes intentional, reckless or negligent disclosure, circulation or dissemination of false or misleading information as to a material fact or its omission
  - which is likely to induce the subscription, sale or purchase of securities, or dealing in futures contracts, or
  - to increase, reduce, maintain or stabilize their prices,
  - then he is **engaged in market misconduct**

- A person who transmits or re-transmits the information**, acting as a conduit, in good faith**, will not be engaging in market misconduct

2.7 Overseas Application

- The controls over market manipulation extend to:
  - Conduct in Hong Kong which affects overseas markets
  - Conduct overseas which affects Hong Kong markets
  - Insider dealing in Hong Kong listed and dual-listed securities

2.8 Safe Harbour Rules

- SFC may make “safe harbour” rules (i.e. exemptions) to ensure market misconduct rules do not prohibit legitimate and internationally acceptable market activities
- An example is the Securities and Futures (Price Stabilizing) Rules which permit and regulate price stabilizing action by issuers and underwriters in respect of public offerings

2.9 Fraud and Deception

- It is an offence in any securities transaction to:
  - Use any device, scheme or artifice to defraud
  - Engage in any act or practice which is fraudulent or deceptive

2.10 Disclosure of Inside Information

- Listed companies **must disclose inside information to the public as soon as reasonably practicable** after the information comes to their knowledge, subject to specific exemptions
- Inside information has come to a listed corporation’s knowledge if:
  - An officer of the corporation, in the course of performing his duties, has knowledge of the inside information
  - A reasonable person, acting as an officer of the corporation, would consider the information to be inside information with regard to the corporation
- **Exemptions** to the disclosure requirement include:
  - Disclosure is prohibited by an enactment or a court order; or
  - Confidentiality of the information is preserved and
    - The information concerns an incomplete proposal or negotiation
    - The information is a trade secret
    - The SFC grants a waiver on disclosure as it is prohibited by overseas legislation or restriction orders
- For **breach of the disclosure requirement** by the listed corporation:
  - An officer will be liable if the breach is caused by intentional, reckless or negligent conduct
  - The listed corporation and/or its directors may be subject to civil liability of a regulatory fine up to HK$8m and/or other sanctions

3. CONSEQUENCES OF MARKET MISCONDUCT

3.1 Market Misconduct Tribunal (MMT)

- The MMT is chaired by a judge with 2 other members who cannot be public officers. **All 3 are appointed by the Chief Executive** of HKSAR
- Can compel and receive evidence relevant to hearings
- A '**balance of probabilities**' standard of proof is applied
- At the conclusion of proceedings, the **MMT will issue a public report** giving details of the market misconduct and the disciplinary orders handed out
- **Appeals** against MMT findings can be made to the Court of Appeal
- The MMT is subject to **judicial review**

3.2 Orders Made by the MMT

- **Orders that may be made by MMT** against those found to have committed market misconduct include:
  - **disqualification** for up to 5 years from holding office as director, liquidator, receiver or taking part in the management of a corporation;
  - **prohibition on investing** or trading in HK markets for up to 5 years (cold shoulder order);
  - **prohibition of further market misconduct** as specified in the order (cease and desist order);
  - **payment of profits made or loss avoided**, plus compound interest, to the Government;
  - **payment of reasonable costs** incurred by the Government and the SFC; and
  - **disciplinary referral orders** recommending that a professional body of which the person is a member should take disciplinary action against him

3.3 Criminal Sanctions Imposed by the Courts

- Criminal sanctions prescribed by the SFO are:
  - **10 years'** imprisonment and **HK$10 million** on conviction and indictment; or
  - **3 years'** imprisonment and **HK$1 million** on summary conviction
- A court may impose sanctions available to the MMT above

3.4 Private Civil Actions

- These are provided under Parts XIII and XIV of the SFO and include:
  - the right to sue for financial loss, even if there are no MMT hearings, criminal actions or convictions, however damages will only be paid if it is 'fair, just and reasonable'
  - the right to use MMT evidence in bringing such an action
  - injunctions
  - any reliefs under common law

4. UNSOLICITED CALLS (COLD CALLS)

- Unsolicited calls include most possible forms of communication made by an intermediary with any person without his express invitation

- Persons exempt from the prohibition:
  - Existing clients
  - Licensed persons
  - Registered institutions
  - PIs
  - Solicitors/accountants acting in their professional capacity
  - Money lenders

- It is an **offense** to engage in the following acts **during an unsolicited call**:
  - Offering to make agreements to buy/sell financial products regulated by the SFC
  - Offering SMF
  - Offering to provide profits, income or other returns from dealing in such financial products

- The person who enters into an agreement as a result of an unsolicited call may rescind the agreement by giving written notice within 28 days of the agreement or, if earlier, within 7 days of discovering the contravention

- The provisions are intended to protect the investing public from:
  - Recklessly giving personal details and money to a stranger
  - Believing a person giving financial advice without checking the person's status or background
  - Buying stock without checking the background of the issuer
  - Opening an account without taking proper precautions

- The Securities and Futures (Unsolicited Calls – Exclusion) Rules state that the prohibition on unsolicited calls does not apply to:
  - Buying or selling securities which the person already owns
  - A "permissible communication"

- A permissible communication is one where
  - it is made to more than one person in identical terms
  - it is made by way of a system that creates a record of the communication which is then available to the recipient for later reference
  - it is made through a system which does not require an immediate response

5. IMPROPER TRADING PRACTICES

- This section considers some unethical practices and market malpractices which are likely to involve a breach of one or more SFC codes, affecting the fitness and properness of an intermediary to hold a license. The practices may also be illegal.

5.1 Boiler Room Activities

- The use of high pressure tactics to sell securities to the public, involving the promise of very high returns
- Features include:
  - Sole use of telephone/email/fax – no face-to-face meetings
  - Seller is often located overseas
  - Investment is being offered to a select group of people for a short time only
  - Investor is pressured into making a down-payment into a bank account followed by calls for further payments
  - Products are exotic-sounding options/bonds/commodities

5.2 Churning (Twisting)

- Excessive selling/buying of investments in a fund/discretionary account with the intention of generating higher commission-based fee income
- Not in the best interests of the client

5.3 Corporate Mis-governance

- Covers all forms of misconduct by the Board of Directors or management towards the company and its members
- Includes fraud, misfeasance and failures to adhere to duties of disclosure

5.4 Front Running

- The use of knowledge of client transactions, by the intermediaries and their employees, to trade for their own account ahead of the clients' trades

5.5 Rat Trading

- Re-allocation of orders to benefit one person at the expense of a client
- Occurs in rising and falling markets

5.6 Unsuitability

- Recommending investments which the intermediary, or its staff, should know are unsuitable for the client

5.7 Unauthorized Trades

- The client has not provided written authorization to a third party/account executive to conduct trades on a discretionary account
- Client claims contract notes/statements have not been received
- No telephone records of orders placed
- May conceal misappropriation by the account executive

6. SFC DISCIPLINARY FINING GUIDELINES (DFG)

- DFG define the considerations SFC will apply when imposing fines
- A fine is a more severe sanction than a public or private reprimand

6.1 General Considerations

- More serious conduct is considered to be that which:
  - Is intentional or reckless
  - Damages the integrity of the market
  - Causes loss or imposes costs on others
  - Provides a benefit to the person
  - Adversely affects the reputation of Hong Kong as an international financial centre

- Less serious conduct, which attracts lower fines, includes conduct that:
  - Is negligent
  - Results in technical breaches (causing little or no damage to the market or loss or costs to others)
  - Results in little or no benefit to the person

6.2 Specific Considerations

- Specific factors considered include whether:
  - A breach of fiduciary duty was involved
  - Conduct showed serious or systemic weakness in management and internal control systems
  - Regulated person benefited from conduct
  - Fine might jeopardize regulated person's business
  - Regulated person reported conduct and cooperated with SFC
  - Regulated person took remedial steps (compensating clients, disciplining staff and preventing recurrence)
  - There was a previous disciplinary record
  - There were other punishments or civil actions

6.3 Public Register

- Disciplinary actions (other than private reprimands), are recorded in a public register

7. ENFORCEMENT ACTIONS

- Examples given of enforcement actions are:
    - An intermediary was reprimanded and fined for breach of the Securities and Futures (Financial Resources) Rules when it had a liquid capital deficiency for 5 business days
    - An intermediary and its responsible officer were reprimanded and fined for failure in internal controls leading to the intermediary's settlement supervisor misappropriating client assets
    - A responsible officer who failed to lodge an authorization form authorizing third party transactions was reprimanded and fined for negligence and non-compliance with order recording requirements
    - A chairman of a listed company was imprisoned for six months, fined and disqualified from being a director of a listed company for one year for price rigging and failure to disclose his interest in shares of the listed company as required by the SFO
    - A retail investor who placed artificial orders to manipulate the final indicative equilibrium price was ordered to perform 60 hours of community service and fined for false trading