TOPIC 9 - OVERVIEW

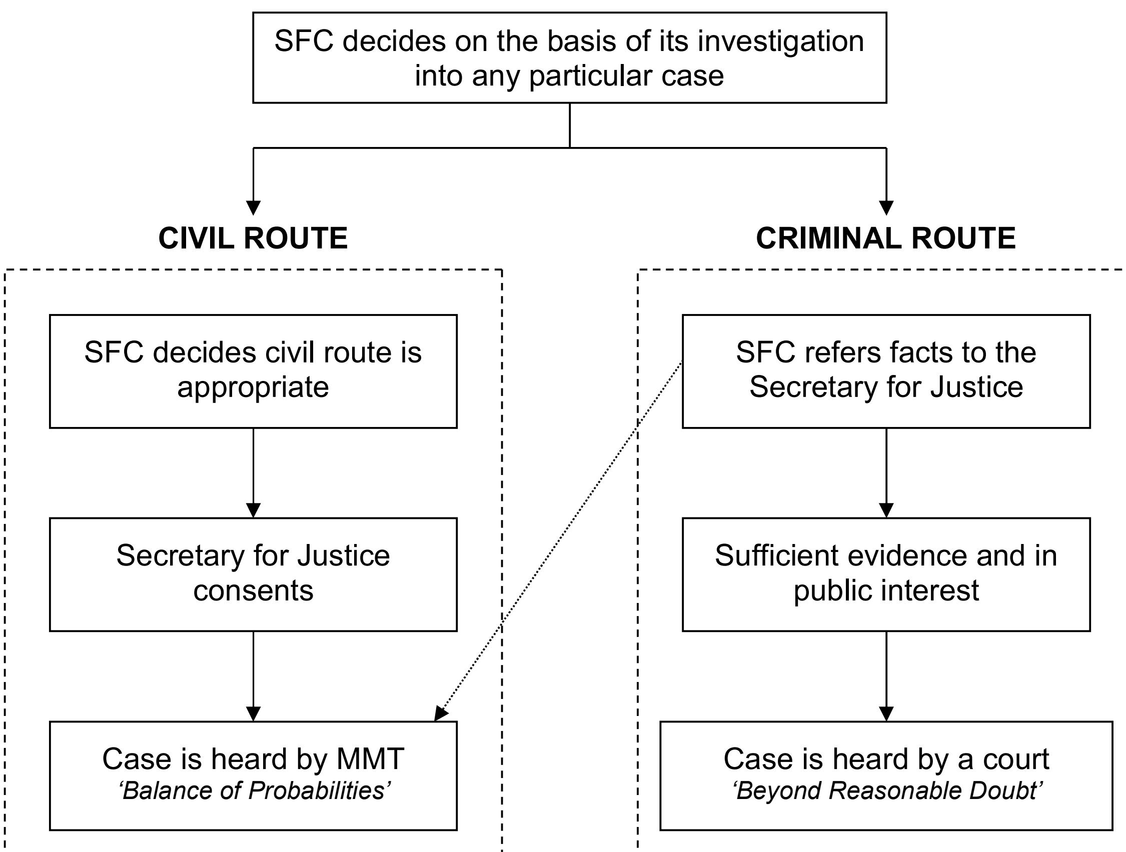
1. MARKET MISCONDUCT UNDER THE SFO

- There are six categories of market misconduct:

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

- Legal proceedings against the accused can be **criminal** in the courts or **civil** under the Market Misconduct Tribunal (MMT), but not both

Criminal or Civil?



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

1.1 Part XIV Offences

- Part XIV specifies 3 further offences which would be prosecuted down the criminal route:
  - Fraudulent or deceptive acts or the use of fraudulent or deceptive devices in Type 1, 2, and 3 regulated activities
  - Disclosure of false or misleading information inducing others to enter into LFE contracts
  - False representations to a person of having dealt in futures contracts on his behalf

1.2 Insider Dealing

1.2.1 Insider Dealing Definitions

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 total number of shares)
  - Professionals who have a business relationship with the corporation (eg auditors)
  - Connected person of another corporation and the inside information relates to transactions between the two corporations

1.2.2 Defences 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 inside 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 inside information

1.3 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

1.4 Price Rigging

- 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

1.5 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

1.6 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

1.7 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. CONSEQUENCES OF MARKET MISCONDUCT

2.1 Market Misconduct Tribunal

- 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**
- **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;
  - **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

2.2 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:

2.3 Private Civil Actions

- 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

3. UNSOLICITED CALLS (Cold calls)

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

- It is an **offence** 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

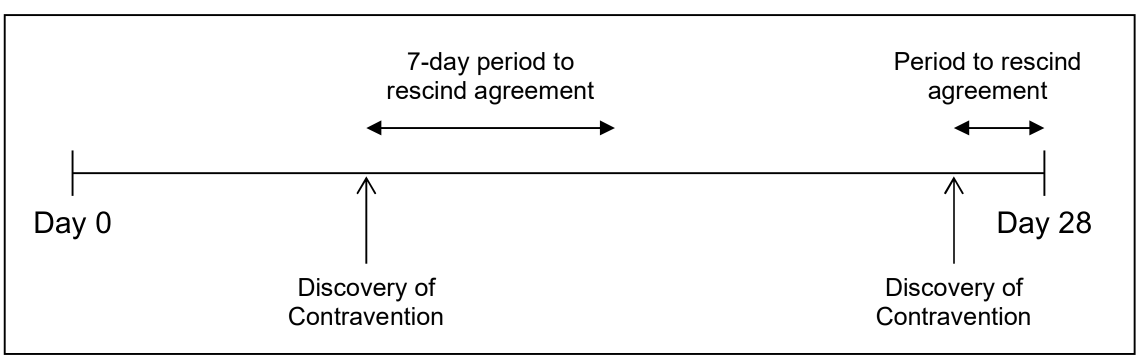
- The provisions are intended to protect the investing public from:
  - Recklessly giving personal details and money to a stranger
  - Believing a person giving financial advice without checking the person's status or background
  - Buying stock without checking the background of the issuer
  - Opening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

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

- The prohibition on unsolicited calls does not apply to an agreement to buy or sell securities to/from a person who already holds such securities

- Unsolicited calls occur when responses are required immediately

- A person who enters into an agreement as a result of such a call may rescind the agreement by giving written notice within 28 days of entering into the agreement or within 7 days of finding out about the contravention, whichever is the earlier



4. IMPROPER 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

- Some of these practices may also be illegal

4.1 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

4.2 Churning

- 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

4.3 Corporate Mis-governance

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

4.4 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

4.5 Rat Trading

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

4.6 Unsuitability

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

4.7 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

5. ENFORCEMENT ACTIONS

- When exercising its powers of enforcement, the SFC's primary concerns are to:
  - Protect investors
  - Maintain market integrity and confidence
  - Hold the wrongdoers accountable for their actions

- SFC's enforcement process involves 3 steps:
  - Identifying suspected breaches
  - Investigation of such breaches
  - Taking steps to protect investors/market and punish wrongdoers appropriately