Burden of Proof

The original Securities and Futures Composite Bill has faced fierce resistance mainly from security houses and merchant banks because it proposes shifting the burden of proof onto them when they are accused of trading misconduct. The politicians have caved in to the bankers; a watered-down version of the bill that essentially maintains the status quo is already passed and will be forwarded to Hong Kong Legislative Council for discussion.

The watered-down version of the bill explicitly states that the burden of proof is on plaintiff when market players are accused of trading mis-conducts with the exception of wash sale and match order (buy and sell at the same price to boost trading volume).

The objective of this article is to show that the concept of burden of proof is misused and misunderstood in Hong Kong. We need to adopt the correct concept that the burden of proof should shift back and forth to allow monitoring authority to initiates a case effectively.

These six mis-conducts are

1. Insider trading,
2. Misleading stock and option trading
3. Manipulating stock and option market prices
4. Manipulating stock market
5. Disclosing the classified information of stocks and options
6. Disclosing misleading information to boost stock and option trading

According to the spokesman and several anonymous decision makers in Financial Services Bureau and Securities and Futures Commission (SFC), that the reversal of burden of proof from defendant to plaintiff is because they have only received one consensus opinion from the following 10 market players.

1. Bear Stearn
2. Credit Suisse First Boston
3. Donaldson, Lufkin & Jenrette
4. Goldman Sachs
5. Jardine Fleming
6. J.P. Morgan
7. Kleinwort Benson
8. Merrill Lynch
9. Morgan Stanley Dean Witter
10. Salomon Smith Barney

The anonymous officer states the following to me in the email

"…Unfortunately the views like yours (burden of proof is on market players) did not come out in the consultation exercise when this subject was hotly debated in the market and the media. It was pretty one-sided. International firms even pointed us to US laws and said that our initial proposals had gone beyond US laws.

At the end we had to strike a reasonable balance between protecting human rights and enhancing prosecution expediency, in order to get the Bill to LegCo. But it would be good if your views can now reach LegCo.
……..

We believe that the advantages of an inquisitorial system under the MMT (Market Misconduct Tribunal) are preserved in the Bill despite the reversal of burden of proof, and this is the gist of the MMT regime. Our exchange with overseas regulators confirm our understanding. Please appreciate that we need to deal with BORO (Bill of Rights Ordinance) and ICCPR (International Covenant on Civil and Political Rights) arguments as well……"

It is evident that Hong Kong government reverses the burden of proof mainly because of the pressure from major market players.

As a matter of fact, the concept of burden of proof under Common Law can be classified into "burden of persuasion" and "burden of going forward with the evidence". The burden of persuasion never shifts from one party to the other at any stage of proceeding, but the latter one which may shift back and forth between parties as the trial progresses. Under the Composite law, the burden of going forward with the evidence stagnates with the government and this is what we are concerned about. I would like to use an example to explain the practice in the US.

We have observed significant short-selling of China Mobile by security houses in early November, 2000. The daily short sale volume constitutes 12-14% of daily trading volume and the one-week short sale volume constitutes around 70% of daily trading volume. As a consequence, on November 8, without any negative information about China Mobile, an analyst with CS First Boston suddenly revised his price target for China Mobile down to HK$49 from a lofty HK$76 just 2 weeks ago. On Nov. 21, CS First Boston further revised China Mobile target price to HK$39.

The misleading information was released by Union Bank of Switzerland Warburg (UBS) that they interviewed Mr. Chen Jinqiao from Ministry of Information Industry on November 24. Mr Chen confirmed that the caller pay system will be implemented in 2001. China Mobile shares plunged more than 20% and hitting a new low of HK$39.60 a week after, consistent with what CS First Boston has predicted. More surprisingly, UBS

announced that Mr. Chen is not from Ministry of Information Industry. UBS's denial clearly shows an evidence of sending misleading information to the market.

If this case were to occur in the US, then First Boston, UBS need to provide evidence to explain the accused manipulation of stock market and misleading information about Mr. Chen if US SEC were to investigate. In other words, the burden of proof shifts to market players. After SEC receives their reply, if SEC is still not satisfied with their explanation, then the burden of proof will shift to SEC to bring up this case to the court with evidence of market manipulation. Both parties are responsible for "burden of persuasion" and let the jury decide if the defendant is guilty or not.

The shift of burden of proof has not occurred in Hong Kong. I have made a formal complaint to SFC, but I was told that it is too difficult for SFC to locate evidence to indict cases like manipulation and disclosure of misleading information because they are understaffing. Clearly that the burden of proof never shifts to market participants in Hong Kong. If the burden of proof never shifts between parties, then security houses are "protected" by the old law and they will be further protected by the new watered down Composite Law for their being accused of manipulation and disclosure misleading information.

I would like to provide evidence of insider trading protected by the old Hong Kong security law. In December 1996, Doubletree Corporation in the US initiated a bidding war to acquire the Renaissance Hotel Group (RHG), an NYSE listed subsidiary of New World Development (NWD) in Hong Kong.

Surprisingly, the increasing momentum of the stock price was initiated before the announcement. The RHG settlement price on 27 December 1996 was only US$13.63. Trading was then boosted, and on 30 December 1996, the day before the announcement, there was an increase in the stock price. The closing price was US$16.38, an increase of 20.18%. Doubletree's announcement on 31 December 1996 further pushed up the stock price of RHG from US$16.38 to US$23.50, at a rate of 43.47%.

The pre-effect of the announcement was due to insider trading (Reuters, 26, June, 1997). A Hong Konger, say Mr. X, purchased 1.4 million RHG common shares at US$15.66 each on 30 and 31 December 1996. Later, on 31 December 1996, it was announced that Doubletree had reached an agreement to acquire RHG. Therefore, the value of the 1.4 million shares increased by US$11 million. Mr. X's account was immediately frozen on January 2, 1997 by the US Securities and Exchange Commission (SEC). Mr X needed to undertake the burden of proof before SEC, but Mr. X chose not to do so. 'As a result, Mr. X had to give up the stock traded and abandon the trading profits, and he was penalized US$2 million. However, the SEC did not disclose how Mr. X had learned of the pending acquisition announcement.

I presented this case to SFC in September 2000, they confirmed with me that the information was leaked by "Investment Advisor" for this acquisition case, but the name of underwriter was not disclosed to me. Since the burden of proof does not shift to Mr. X, hence the case has never been brought up to the court in Hong Kong.

Mr. Andrew Sheng, Chairman of SFC, stated on Jan 9, 2001 in the press conference that the notion of burden of proof on plaintiff (Hong Kong government) is based on the dictation of Common Law. His view is also consistent with opinion from the Hong Kong Bar Association according to Hong Kong Economic Journal on Jan 7, 2001. I would like to reinforce that "burden of going forward with the evidence" could shift back and forth between parties under the Common Law regime. It is not for Hong Kong government to be responsible for all burden of proof.

I would like to provide evidence to show that Common Law does not have this implication.

In 18 century, the Royal Courts of Henry II in England had laid the foundations of the Common Law. However, the Magna Carta in the UK in the 13 century has already dictated that the suspects are assumed innocent until they are proved guilty. Hence, it constitutes the practice that the burden of proof is on plaintiff under the criminal law. The foundation of assumed innocent was drafted long before Common Law was born, hence it is clearly not the implication of Common Law.

In the US, the Common Law has also been shaped around the same time in 18 century, but the security law dictating that burden of going forward with the evidence was enacted in 1934 under the Common Law regime.

We should not use the Common Law as an excuse to defy the adoption of a correct concept of "burden of proof". I would urge the Legislative Council to reverse the burden of proof issue in the Bill by adopting the US practice to bring in both "burden of persuasion" and "burden of going forward with the evidence" into the Bill to enhance the governance power of SFC.

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