

Guide to

Legislative Proposals on

Establishing a Market Misconduct Tribunal

(to be included in the Securities and Futures Bill)

5th July 1999

Introduction

1. In Hong Kong market manipulation and related criminal offences are contained in Part XII of the Securities Ordinance and Part VI of the Commodities Trading Ordinance. The relevant provisions have proven to be inadequate to cover all forms of market manipulation. Therefore, in the Composite Bill they will be revamped to articulate clearly to the market what is unacceptable conduct.

Present difficulties

2. However, notwithstanding the proposed changes to the law, unless the system to tackle market manipulation changes, it will still rely on the criminal law which has, for the following reasons, proven to be ineffective in dealing with sophisticated market manipulation:
 - given the technological advancement in recent years, manipulation, although orchestrated from Hong Kong, can appear to originate from other jurisdictions;
 - those perpetrating abuse can hide behind various guises to hide their true identity;
 - the funding of the abuse can be complex, involving several jurisdictions; and
 - more than one market can often be involved.

Therefore, since the introduction of the current legislation in 1974, there have been only two prosecutions for market manipulation. In each case, there was a guilty plea and in each case only a suspended sentence was imposed. The

reason for this is that it is difficult, and often impossible, to prove each element of a criminal offence “beyond reasonable doubt”.

3. The result of this situation is that although the criminal offences for market manipulation are designed to provide a real deterrent, in reality they have proven to be ineffective. Therefore, consideration must be given to an alternative means to tackle such abuse which can affect Hong Kong’s reputation and standing as a leading financial centre if our markets are not perceived to be fair, efficient and transparent.

Insider Dealing Tribunal

4. One form of market abuse is “insider dealing”. This is combated by the Insider Dealing Tribunal (“IDT”) established under the Securities (Insider Dealing) Ordinance (Cap 395) which was enacted in 1991. The IDT has proven to be extremely effective in dealing with this sophisticated form of market misconduct.¹
5. The advantage of proceedings before the IDT is that unlike criminal proceedings, proof of matters before the IDT is not to the criminal standard, namely beyond reasonable doubt.

Recommended Approach – Market Misconduct Tribunal

6. This paper will recommend that we build on Hong Kong’s success in tackling insider dealing by expanding the role of the IDT to cover other forms of market abuse in the nature of market manipulation in addition to insider

¹ In the past five years ten cases have been finalised, and one case is awaiting a decision. Of the ten case concluded, seven resulted in the IDT finding a total of 14 persons as insiders. They were banned for varying periods from being directors of listed companies and were subject to pecuniary sanctions totaling some \$57 million.

dealing. The opportunity will also be taken to clarify the scope of the IDT to take account of the experience gained of its operation since its inception.

The IDT, which would be renamed the Market Misconduct Tribunal (“MMT”), would operate in much the same manner but with an expanded role.

7. Such a concept was introduced by the Financial Secretary in his 1999 budget speech when he stated that in positioning Hong Kong’s securities and futures market for the next millenium there will be introduced in the Composite Bill an independent MMT.

The Concept of Market Abuse in the UK

8. The United Kingdom’s proposed Financial Services and Markets Bill (“the FSMB”) introduces a radical concept of “market abuse” which will be defined in a Code of Conduct (“the Code”) that can be made by the Financial Services Authority (“FSA”). Under a draft of this Code it is recommended that a failure to comply with the Code will be admissible as evidence of a breach of the statutory precepts. The FSMB empowers the FSA to fine (unlimited amounts) for market abuse.
9. The draft Code basically defines market abuse to be “insider dealing” and “market manipulation”. It specifically considers and rejects extending the concept of “market abuse” to “front running”, which is abuse of information regarding order flow. This approach is supported, as such abuse is a failure of fiduciary duty towards a client and should be dealt with in Codes of Conduct relating to the conduct of licensed persons.

The Case for Hong Kong

10. In Hong Kong little can be gained in regulatory effectiveness in fully adopting the FSMB's approach. There are technical difficulties seen in the concepts used in the FSMB's definition of market abuse, for example the concept of "informed participant" is seen by some as likely to cause confusion and uncertainty.
11. Hong Kong already has an effective IDT that is an independent body chaired by a Judge. It is recommended that this tribunal be renamed as the "Market Misconduct Tribunal", and that its role be expanded to deal with both insider dealing and market manipulation (and related market offences).

The Composite Bill

12. The Composite Bill will spell out what constitutes market manipulation, largely following the language of the Australian Corporations Law. In doing so, the bill will rectify the known defects in Part XII of the Securities Ordinance and Part VI of the Commodities Trading Ordinance and closes possible loopholes in the current market misconduct provisions. The result is that the Composite Bill will clearly articulate what is unacceptable market conduct.

Definitions for Market Misconduct

13. The Composite Bill prohibits:
 - (a) the creation of a false and misleading appearance of active trading, or with respect to the market for or the price of dealings in securities or futures contracts;

- (b) the creation of a false and misleading appearance of active trading by the use of wash sales (i.e. a person, or his associates offering to buy and sell securities at the same price);
- (c) maintaining, increasing reducing or causing fluctuations in the price of securities by wash sales or in the price of securities and futures contracts by fictitious transactions or devices;
- (d) the dissemination of information about illegal transactions in securities or futures contracts by a person who, or whose associate has, engaged in illegal transactions or has received, or expects, a benefit as a result of the dissemination;
- (e) carrying out a transaction or transactions that increase, reduce or stabilise prices with the intention of inducing others to sell, purchase, subscribe for or to refrain from selling or purchasing or subscribing for securities;
- (f) the dissemination of false or misleading information that may induce the sale or purchase of securities, or induce persons to deal in futures contracts or raise lower or stabilise the market price for securities, or for dealing in futures contracts;
- (g) in a transaction in securities or futures contracts, fraud or deceit of a particular person, fraudulent or deceptive conduct and the making of an untrue and misleading statement without an honest and reasonable belief that it is true; and
- (h) bucketing of futures contracts.

The prohibitions detailed at (a) to (f) involve conduct affecting the market as a whole whilst the prohibitions detailed in (g) and (h) involve specific acts of fraud against an individual.

14. The Composite Bill proposes that the prohibitions outlined in paragraphs 13(a) to (f) above be dealt with civilly by a MMT with the perpetrators being subject to pecuniary sanctions. It also propose that the prohibitions detailed at paragraphs 13(g) to (h) above be criminal offences and that the penalties be increased to a maximum fine of \$10 million and 14 years imprisonment on indictment and a fine of \$1 million and 3 years imprisonment on summary conviction.
15. These provisions fill the known deficiencies in the existing law and introduce more appropriate sanctions. As these provisions are modeled on the Australian Corporations Law they would also have the benefit of being partly settled by judicial interpretation. Therefore, there will be a body of judicial interpretation for reference. Under the Composite Bill, the Securities and Futures Commission (the “Commission”) may also apply to Court for orders restraining market abuse and an order that a person takes steps to remedy a contravention.

Operations of the Market Misconduct Tribunal

16. As is the case with the IDT, the MMT would be headed by a Judge or Deputy Judge of the High Court, and would be assisted by two market practitioners appointed for a particular hearing by the Chief Executive.
17. It is envisaged that the MMT would assume the jurisdiction of the present IDT. In addition, its role would be expanded whereby the Financial Secretary would be able to initiate proceedings before the Tribunal into whether or not other types of market misconduct (as detailed in paragraphs 13(a) to (f)) have, or may have taken place. All proceedings before the MMT will be conducted

by an independent Tribunal Officer who will be appointed by the Secretary for Justice. This Tribunal Officer will no longer be a counsel appointed to assist the Tribunal but will act independently of the Tribunal with a role not only to present the case but also to initiate such further inquiries as he considers necessary, or he may act under instructions of the Tribunal.

18. The MMT would not have jurisdiction to impose criminal penalties but would be able to order disgorgement of the proceeds of misconduct and to make orders disqualifying a person implicated in market misconduct from acting as a director or officer of a corporation for a period of 5 years. In addition it would be empowered to order a person to pay, as a pecuniary penalty, the greater of an amount:
 - (a) not exceeding \$10,000,000; or
 - (b) not exceeding three times the amount of profit gained or loss avoided by the person as a result of his misconduct.

The current IDT only has the power set out in (b). The additional power at (a) is being introduced to cater for cases of market misconduct in which it may not be possible to identify the profit gained or loss avoided whilst the conduct involved damaged, or potentially damaged the market. To provide this additional power to the MMT should provide a further deterrent to those contemplating market abuse.

19. In addition to insider dealing, the MMT would have jurisdiction over various forms of manipulation in the securities and futures markets. The specific forms of market manipulation are clearly articulated in the Composite Bill and, as already mentioned, provide market participants with certainty and predictability. In addition, the Commission may provide further guidance to

the market as to the types of matters it would investigate with a view to recommending to the Financial Secretary that he make a referral to the MMT.

Division of Responsibilities

20. There will, as in the case of the IDT, continue be a clear separation of functions between the Commission as the investigatory authority, the Tribunal as an adjudicative body, the Tribunal Officer as an independent counsel tasked with presenting the case and initiating further inquiries (should these be necessary) as a case develops, and the Financial Secretary who will have discretion to refer or not refer a matter to the MMT.

The Sanctions for Market Misconduct

21. Under this proposal, only matters that involve specific fraudulent acts against an individual will continue to constitute criminal offences, with increased penalties. The MMT will deal with misconduct that affects the market as a whole. This approach preserves criminal standards for matters involving moral turpitude. The remaining prohibitions on market abuse will be dealt with by the MMT, which will have available to it the sanctions detailed in paragraph 18 above.

Public Consultation

22. To enhance Hong Kong's position as an international financial centre, it is important that its markets are perceived to be fair, efficient, and transparent. In order to achieve this objective, there must be effective laws in place to tackle conduct which adversely affects the securities and futures markets, as well as specific acts of fraud against individual persons. The Composite Bill will clearly articulate which is unacceptable market conduct by filling the known deficiencies in existing law and introducing more appropriate sanctions.
23. In the case of specific acts of fraud against individual persons, it is proposed that these remain as criminal offences. However, given the complexities of misconduct that can affect the securities and futures market as a whole, it is necessary to reappraise the traditional reliance on criminal law with its attendant problems of proof. A shift in emphasis is therefore necessary to combat sophisticated market misconduct to provide a more effective response to activities that can seriously impact the market. The Composite Bill will propose that such conduct be dealt with civilly.
24. The IDT has been successful in tackling one form of market misconduct, i.e., insider dealing. It is proposed that the role of the IDT be expanded to cover other forms of market misconduct when that conduct affects the market as a whole. The IDT will be renamed the Market Misconduct Tribunal and have available to it the necessary sanctions.
25. The Government and the Commission believe the proposals detailed in this Guide will improve the regulatory framework and put it on par with the best of international standards, thereby enhancing Hong Kong's competitiveness as an

international financial centre. Comments and views are sought from the financial community and general public. Please write to the Securities and Futures Commission, 12th floor, Edinburgh Tower, The Landmark, 15 Queen's Road, Central, Hong Kong or e-mail to <newbill@hksfc.org.hk>. In view of the tight legislative timetable, we would be grateful if your comments and suggestions could reach the Commission before 6 August 1999.