

**For discussion on
3 April 2006**

Legislative Council Panel on Financial Affairs

Regulation of Market Misconduct

PURPOSE

This paper briefs Members on the different types of “market misconduct” under the Securities and Futures Ordinance (SFO) and the procedures adopted by the Securities and Futures Commission (SFC) in handling such cases.

BACKGROUND

2. Parts XIII and XIV of SFO provide for a dual regime, i.e. parallel civil and criminal regimes, to deter market misconduct. SFC as the statutory regulator is responsible for identification and investigation of market misconduct.

3. A member of the Panel on Financial Affairs has suggested that given the incidents in recent years involving market misconduct, it is necessary to examine the current regulatory regime and ensure that it is fair and effective. Response to the issues raised by the Panel member is at **Annex**.

SFC's Submission for Item V of the FA Panel Meeting on 3 April 2006

1. **Under Section 245(1) of the Securities and Futures Ordinance (SFO), “disclosure of false or misleading information inducing transactions” within the meaning of Section 277, is regarded as a market misconduct act; and under Sections 298 and 384, “disclosure of false or misleading information inducing transactions” and “provision of false or misleading information” are regarded as offences. As the law enforcement agent of the securities and futures markets, on what basis would the SFC decide whether or not to exercise its statutory power to collect evidence and conduct investigations into any market misconduct that may have contravened the above provisions?**

1. Parts XIII and XIV of the Securities and Futures Ordinance (SFO) establish a dual civil and criminal regime to combat various forms of “market misconduct”: insider dealing (Ss270 and 291), false trading (Ss274 and 295), price rigging (Ss275 and 296), disclosure of information about prohibited transactions (Ss276 and 297), disclosure of false or misleading information inducing transactions (Ss277 and 298) and stock market manipulation (Ss278 and 299).

Under Part XIII, a Market Misconduct Tribunal is established. Only the Financial Secretary may institute proceedings in front of the MMT. The MMT has wide powers to take and hear evidence and, applying a civil standard of proof, to make findings of market misconduct. It may impose a range of sanctions including ordering profits of market misconduct to be disgorged and banning people from having access to the Hong Kong securities markets or from being directors of listed corporations.

Under Part XIV, criminal offences of market misconduct are established. The SFC may bring proceedings for criminal market misconduct before the Magistrates Court where the maximum sentences that can be imposed are 3 years imprisonment and a HK\$1 million fine. More serious cases are transferred from the SFC to the Police. The Department of Justice will then prosecute on indictment when the maximum penalties are 10 years imprisonment and a HK\$10 million fine.

Under Part XVI, SFO, Section 384 makes it an offence for any person, in purported compliance with a statutory requirement to provide information, to provide the SFC or the Stock Exchange with information that is false or misleading in a material particular. This offence may be prosecuted by the SFC in the Magistrates Court or by the Department of Justice on

indictment. The maximum penalty on indictment is 2 years imprisonment and a HK\$1 million fine.

The SFC will exercise its statutory powers to investigate under Section 182, SFO when it has reasonable cause to believe that market misconduct or an offence under Section 384, SFO has been committed.

The SFC identifies potential cases of concern from its market surveillance, from its participation in the Dual Filing regime with the Stock Exchange and from performing its other regulatory functions. It also receives and assesses complaints and referrals from other regulators, law enforcement bodies, industry, investors and members of the public. All external complaints are considered by the Complaints Control Committee which decides whether or not to entertain a complaint. The CCC is chaired by a senior member of management from the Chairman's Office and comprises representatives of all operational divisions. Complaints are referred to operational divisions in accordance with written criteria. The Enforcement Division follows well established written procedures when processing market misconduct and other cases. These are designed to ensure fairness, consistency and internal checks and balances on decision-makers.

2. **Since the SFO came into effect, the SFC has conducted investigations into how many cases of possible breaches of Sections 277, 298, 301 and 384¹ of the Ordinance? How many of those cases were investigated by the SFC on its own initiative, and how many of them were complaints or referral cases from external parties? Please classify by the provisions which may have been contravened and the ultimate number of cases in respect of which enforcement actions were taken by the SFC.**

2. Since the SFO came into effect, the SFC has conducted investigations into possible breaches of Sections 277, 298, 301 and 384 of the Ordinance as follows:
 - (i) Sections 277 and 298 – 11 investigations (of which 7 are complaints or referrals and 4 are SFC generated).
 - (ii) Section 301 – no investigations.

¹ Section 277 “disclosure of false or misleading information inducing transactions”, section 298 “offence of disclosure of false or misleading information inducing transactions”, section 301 “offence of disclosure of false or misleading information inducing others to enter into leveraged foreign exchange contracts” and section 384 “provision of false or misleading information”

- (iii) Section 384 – 26 investigations (of which 8 are complaints or referrals and 18 are SFC generated).
- (iv) 1 case under Section 277 SFO has been referred to the Financial Secretary to consider instituting proceedings in the Market Misconduct Tribunal.
- (v) In 3 Section 277/298 cases investigations are in progress, 2 cases have been referred to the Police and 5 cases have been curtailed.
- (vi) 2 Section 384 cases have been prosecuted; 1 case is awaiting plea; 11 cases investigations are in progress; 2 cases have been referred to the Police; 1 case has been referred to ICAC; in 1 case we offered no evidence under Section 384 and the defendant was prosecuted for other offences and 8 cases have been curtailed.
- (vii) On 22 September 2004, Huafeng Textile International Group Limited and one of its directors, Mr. Cai Yang Bo, pleaded guilty to breaches of Section 384 and were fined HK\$50,000 each in the Magistrates Court.
- (viii) On 16 January 2006, Mr. Benby Chan, a Director of Asia Aluminium Holdings Limited, was acquitted after trial in relation to an alleged breach of Section 384.
- (ix) In addition, the SFC has brought 8 prosecutions under Section 295 (offence of false trading) of which 3 have been successful, 4 await trial and 1 has been withdrawn.
- (x) The SFC has continued to bring prosecutions under pre-SFO provisions for suspected market manipulation that took place before 1 April 2003. These provisions broadly mirror the terms of the offences provided in Part XIV SFO. In the last three years, the SFC has prosecuted 33 cases under the Securities Ordinance and the Commodities Trading Ordinance. 3 cases resulted in acquittals, 5 cases were withdrawn and absolute discharges were given in two cases. The remainder (23) were successful and resulted in sentences ranging from fines to periods of immediate imprisonment.

3. How does the SFC determine what is “false” and “misleading” information?

- 3. To investigate suspected market misconduct under Section 277, SFO and offences under Sections 298 and 384, the SFC seeks to establish the facts underlying the information that has been disclosed to the market. For example, if a listed corporation makes a public announcement of price sensitive information that does not square with information available from other sources, the SFC will review all available information and interview

those likely to have information relevant to the inquiry including senior management at the company in an effort to establish how the announcement came to be made and the truth or otherwise of its contents. If the terms of the announcement do not accord with the facts it is likely to be incorrect and therefore false. Note, however, that the law requires that it must be false “as to a material fact” or is false “through the omission of a material fact”. Accordingly, minor misstatements or errors would not lead to liability under these sections. Establishing the facts also enables the SFC to assess whether an announcement is misleading in the sense of being confusing to the point of being deceptive. Again, liability arises only in relation to material facts or their omission.

For the purposes of Sections 277 and 298, SFO, it is necessary also to prove that the information disclosed is likely to induce another person to subscribe for or buy or sell securities in Hong Kong or is likely to maintain, increase, reduce or stabilize the price of securities. This may require expert evidence that can be challenged or contradicted at trial or in an MMT hearing.

To prove that an offence has been committed under either Section 298 or Section 384, it is also necessary to establish that a person knows, or is reckless as to whether, the information is false or misleading in a material particular. This is not necessarily a straightforward matter when an individual such as a director places reliance on others to produce information that he discloses only to find out later that it is false or misleading. What amounts to recklessness in this context remains untested but is subject to the general criminal law which holds that a defendant can only be convicted on the basis of recklessness if he actually appreciated the risk involved and then unreasonably took that risk.

4. How does the SFC ensure the impartiality and credibility of the investigations and enforcement actions on market misconduct?

4. The impartiality and credibility of the SFC’s investigations and enforcement actions is ensured by the internal and external checks and balances on its procedures and decision-making which are designed to ensure fairness, consistency and observance of due process.

The SFC cannot refer a case of market misconduct to the MMT itself. It can only report matters that it reasonably believes to constitute market misconduct to the Financial Secretary who decides, having taken legal

advice, whether to institute proceedings before the MMT. The decision of the MMT may be appealed to the Court of Appeal.

The SFC may prosecute offences under Part XIV and Section 384 in its own name

in the Magistrates Court. It does so after obtaining legal advice from its Legal Services Division that such action stands reasonable prospects of success. The Magistrate determines whether or not the behaviour complained of constitutes a criminal offence, not the SFC. A Magistrate's decision may be appealed to the High Court.

More serious suspected market misconduct offences will be transferred to the police for further investigation and prosecution by the Department of Justice, if so advised. Thus, the SFC's initial investigation is subject to scrutiny from outside and any decision to prosecute is taken outside the SFC.

The SFC's internal procedures are subject to judicial review for any perceived unfairness in its processes and decision-making. Two judicial review applications were made to the court in 2004 and 2005 and both failed.

The SFC is also subject to scrutiny by the Ombudsman and by the ICAC under the Prevention of Bribery Ordinance. The Corruption Prevention Department of the ICAC also regularly audits the work of the Enforcement Division and last did so in 2005.

The SFC's detailed procedures are subject to the review and advice of the Process Review Panel (PRP). This is an independent, non-statutory panel established by the Chief Executive in November 2000 to review the internal operational procedures of the SFC and to determine whether the SFC has followed its internal procedures, including procedures for ensuring consistency and fairness and to make recommendations to the SFC in relation to these objectives.

The PRP comprises twelve members including nine members from the financial sector, academia and the legal and accountancy professions, and three ex-officio members including the SFC Chairman, a Non-Executive Director of the SFC and a representative of the Secretary for Justice.

The PRP reports to the Financial Secretary annually and those reports are made public.

The PRP was established to improve the transparency of the SFC's internal processes so that the public would be better able to see that the SFC does indeed act fairly and consistently in the exercise of its powers including its powers in the market misconduct regime. In establishing this body, the Administration acknowledged that the SFC's ability to demonstrate that it acts in this fashion is necessarily constrained by statutory obligations of secrecy which limit the extent to which the SFC can divulge information to the public regarding what it has or has not done.

The PRP has jurisdiction to call for and review all completed or discontinued cases involving the exercise of statutory powers of investigation, inquiry and prosecution for the purpose of verifying that the action taken and decisions made in relation to the case are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly. It also may check on how the SFC has dealt with complaints against staff.

The SFC considers that all the above checks and balances combine to ensure that the SFC is consistent, fair and accountable for its actions when dealing with market misconduct amongst other things.

- 5. While the SFC is prohibited by the secrecy provisions from disclosing any information on any relevant investigations during the investigation period, can the SFC announce its decisions and the related reasons after the completion of investigations and prosecutions, or after it has been decided that no investigations or prosecutions are to be made in order to increase the transparency of the SFC's enforcement actions?**
5. The SFC and its employees are bound by the terms of Section 378, SFO to preserve and aid in preserving secrecy of any matters coming to their knowledge in performing the functions of the SFC. Unless disclosure of information subject to the secrecy obligation is expressly permitted by the terms of Section 378, it is strictly prohibited. Section 378(3) sets out the avenues for lawful disclosure of information by the SFC including, for example, to the Hong Kong Monetary Authority, the Police, the ICAC, the Ombudsman and the Stock Exchange.

No mechanism exists for disclosure to be made of investigations that do not result in enforcement action. However, the SFC publicizes the results

of all concluded prosecutions, finalized disciplinary orders and rulings of the Insider Dealing Tribunal and the MMT.

Section 378, SFO is comparable to the secrecy provisions applying to regulators in other international financial centres and complies with the international benchmark for cross-border co-operation: the International Organization of Securities Commission (IOSCO) Multilateral Memorandum of Understanding.

The high level of confidentiality demanded by Section 378 serves the public interest by protecting the efficacy of the SFC's performance of its functions while safeguarding the rights of those under investigation or undergoing disciplinary action from trial by media on unsubstantiated suspicions.

6. If the SFC cannot disclose the relevant information even after deciding not to conduct investigation, what measures will the SFC take to ensure that the public can monitor the enforcement work of the SFC in an effective manner, in order to protect the interests of small investors?

6. In our answer to question 3 above we have described the role played by the PRP in monitoring the performance of the SFC generally including its enforcement work. We consider that the PRP plays an effective part in ensuring that the SFC acts fairly and consistently in the exercise of its powers. Its status as an independent committee that issues annual reports commenting on its review of the SFC's work enhances the transparency and public accountability of the SFC. We do not consider that further specific measures are necessary to protect the interests of small investors.

7. What principles does the SFC use in deciding whether or not different cases should be referred to the "Market Misconduct Tribunal"?

7. The SFC does not refer cases to the MMT. The Board of the SFC decides whether or not to refer cases of suspected market misconduct to the Financial Secretary who, having taken his own legal advice, decides whether to institute proceedings in the MMT.

In considering whether to refer a case to the FS, the SFC Board will consider legal advice from the Legal Services Division of the SFC on the evidence found by the Enforcement Division in its investigation. That

advice will assess the prospects of successfully pursuing the case in the MMT as opposed to prosecuting the case through the criminal courts bearing in mind the different standards of proof that apply in each. The range and nature of the sanctions available in the MMT as opposed to the courts may also influence the choice of forum as might the availability of market expertise amongst the lay members of the Tribunal. It is not possible to identify an exhaustive list of factors relevant to this assessment which will vary with the particular facts of each case.

Securities and Futures Commission
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