

## NOT (ONLY) FOR PROFIT? HONG KONG COURT OF FINAL APPEAL CLARIFIES INNOCENT PURPOSE DEFENCE IN INSIDER TRADING

In a four-to-one majority decision, the Court of Final Appeal (CFA) has allowed an appeal by the Securities and Futures Commission (SFC) against findings by the Market Misconduct Tribunal (MMT) that two former listed company executives had established a defence under the Securities and Futures Ordinance (SFO) which provides that a person should be acquitted of insider dealing if they did not have the purpose of securing a profit by using inside information.

### BACKGROUND

Yiu Hoi Ying Charles and Wong Nam Marian were the Director of Finance and Company Secretary respectively of a listed company, Asia TeleMedia Limited (ATML). In July 2002, ATML owed a third party, Madam Liu, sums totalling nearly HK\$84 million (which it promised to repay by instalments) and was technically insolvent. ATML defaulted numerous times in its repayments to Madam Liu and whilst she served five statutory demands on ATML, each occasion resulted in a negotiated outcome, not a winding-up petition. In February 2007, Madam Liu assigned the balance of ATML's debt to Goodpine Limited. Goodpine served a statutory demand on ATML on 26 April 2007, stating that it would petition to wind up the company if it failed to pay the full amount within 21 days. The public was never informed of the assignment, but in the meantime a surge of speculative interest in ATML shares saw their share price rocket.

Charles and Marian both exercised share options between 28 February 2007 and 5 June 2007, realising substantial profits each in excess of HK\$5 million. On 6 June 2007, Goodpine presented a winding-up petition and trading was suspended. When trading resumed on 18 October 2007, the share price had fallen by 62%. Before a winding-up order could be made, a scheme of arrangement was agreed with a third party, with a renamed ATML deriving its remaining value from its status as a "listed shell" company.

A MMT was established to examine whether there had been insider dealing. It found that the debt assignment and the statutory demand constituted inside information. It also found that both Charles and Marian knew that the information, if it fell into the public domain, would be likely to have a material effect on the ATML share price. The Tribunal found that both committed insider dealing under section 270(1) SFO but they should be acquitted by virtue of a statutory defence. The Court of Appeal agreed with the MMT's

### Key issues

- The Court of Final Appeal has ruled that two inside dealers could not rely on an "innocent purpose" defence to escape culpability.
- Establishing that the dealing would have occurred even without possessing the inside information is not sufficient for the purpose of the defence under section 271(3) SFO.
- Its ruling overturned decisions by the Market Misconduct Tribunal and the Court of Appeal.
- The SFC said the case involved important points of law that go to the heart of the insider dealing regime.

finding. The CFA in *SFC v Yiu Hoi Ying Charles* [2018] HKCFA 44 considered matters afresh.

## **AN INNOCENT PURPOSE**

The defence relied upon by the respondents was section 271(3) SFO which states that: *"a person shall not be regarded as having engaged in market misconduct by reason of [insider dealing] ... if he establishes that the purpose for which he dealt in [the listed securities] ... did not include, the purpose of securing or increasing a profit... by using relevant information."* It is known as the *"innocent purpose"* defence and, as summarised by the CFA:

- is a defence which only comes into play where a *prima facie* case of market misconduct has been established;
- the burden of establishing the defence is on the person seeking to rely on it, on the balance of probabilities;
- the person must establish that the purpose for which they dealt with the securities was not and (if there was more than one purpose) did not include, the proscribed purpose of securing or increasing a profit by using relevant information;
- to discharge that burden, the person might often be expected to give direct evidence of their subjective purpose to show they were acting for what might be called an *"innocent purpose"*. If such direct evidence is not given, the person must nonetheless be able to point to evidence which demonstrates that they acted for a purpose or purposes which entirely excluded the proscribed purpose when dealing with securities; and
- the purpose must be that which pertained *at the time of the dealing* in the securities.

Charles and Marian had argued that their sole purpose in selling their shares was to secure an unexpectedly high profit. They could only rely on the section 271(3) defence if they could show they did not use inside information to secure the profits.

## **BEHIND CLOSED DOORS**

The MMT had been persuaded that the respondents had established the defence by accepting the so-called *"behind closed doors"* justification – that both Marian and Charles had believed that *"somehow, however slow and muddled the process"*, the company's financial situation would be *"dealt with behind closed doors"* (as had historically been the case with Madam Liu) and *"would not therefore become a matter to influence the market"*.

The CFA found the MMT to have erred in law in holding that the justification was available to the respondents. Marian and Charles had sold their shares taking full advantage of their knowledge that the prices and profits they were securing would not be achievable if the information were to find its way into the market. The CFA held that they turned the possession of their knowledge into action, which constitutes the *"use"* of inside information.

The majority (Chief Justice Ma, Mr Justice Ribeiro PJ, Mr Justice Fok PJ and Lord Neuberger of Abbotsbury NPJ) noted that *"the fact that the information does not in fact become known to the public in any particular case does not stop it from being inside information so long as it can be shown that if it were disclosed, it would affect the share price."* (original emphasis). Their belief as

to what might happen in the future to resolve the company's dilemma in the future was irrelevant.

The majority therefore held that Charles and Marian failed to establish the "*innocent purpose*" defence and were guilty of market misconduct by insider dealing. The CFA set aside the orders made by the Court of Appeal and the MMT and remitted the matter back to the MMT to deal with sanctions.

## AN ALTERNATIVE VIEW

Mr Justice Tang PJ, in a dissenting judgment, held that the section 271(3) defence should be interpreted to provide a defence for a defendant who can show they would have done what they did even if they did not have the information. He agreed with counsel for the second respondent that the object of section 271(3) was that innocent dealing should not be prohibited, a view which prevailed in England & Wales and which also had been the view of the Hong Kong Companies Law Revision Committee, which in 1973 proposed that "*the provisions should be restricted so as to apply to people acting with a guilty intention*".

According to Tang PJ, more than simply dealing whilst in possession of the relevant information was required. Tang PJ found the MMT was entitled to hold that Charles and Marian, like ATML's other employees, sold their shares because of the speculative bubble that was taking place and that the relevant information was not a factor.

## WELCOME CLARIFICATION

With the CFA's clarification of the proper scope of the "*innocent purpose*" defence under section 271(3) SFO, it remains to be seen how insiders can avail themselves of the defence save in cases of dealing under compulsion (a point which the CFA declines to determine in the present appeal). The CFA only notes that the defence might arise, for instance, where a person deals in the securities pursuant to a prior contractual obligation and has to sell whether it entails realising a profit or loss, or where a person sells shares in compliance with a Court order.

The SFC's Executive Director of Enforcement, Thomas Atkinson, said: "*We are pleased with the Court's decision. This case involves important points of law which go to the heart of the insider dealing regime. The SFC will continue to robustly combat insider dealing as it undermines the fairness and integrity of the market*".

In his foreword to the decision, Chief Justice Ma describes insider dealing as an "*insidious activity that is detrimental to the reputation of any major financial centre*". Those charged with ensuring the integrity of Hong Kong's reputation for honesty and transparent financial dealing will be heartened by the CFA's ruling, but may yet wonder about the length of time it has taken to reach it.

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