ON THE INSIDE - HONG KONG COURT OF FINAL APPEAL DISMISSES SOLICITOR'S APPEAL IN FRAUD CASE

The Court of Final Appeal (CFA) has unanimously dismissed an appeal by a solicitor against a decision of the Court of First Instance (CFI), upheld by the Court of Appeal, that he and two others had contravened section 300 of the Securities and Futures Ordinance (SFO) by engaging in fraud or deception involving securities listed outside Hong Kong. The decision has been welcomed by the Securities and Futures Commission (SFC) as an important step in enforcing insider trading laws even where the actual execution of the transaction takes place on overseas exchanges.

Key issues

- The Court of Final Appeal has confirmed that section 300 of the Securities and Futures Ordinance covers a wide range of activities taken to make a profit or avoid a loss by the misuse of inside information in transactions involving securities.
- Wrongdoers may still be pursued even if the actual execution of transaction takes place overseas.
- It will be interesting to note whether the statutory provision in question will be used in future for other types of securities fraud.

BACKGROUND

In December 2010, the Securities and Futures Commission (SFC) commenced civil proceedings under section 213 of the SFO against the solicitor, Eric, his two sisters, Patsy and Stella, and another solicitor Betty, for fraud and/or deception in transactions involving the shares of Hsinchu International Bank Company Limited (Hsinchu), listed on the Taiwan Stock Exchange, and for insider dealing in the shares of Hong Kong-listed Asia Satellite Telecommunications Holdings Limited (AsiaSat).

The SFC's case was that Eric acquired confidential material price-sensitive information (CMPSI) when another team of lawyers in the law firm in which he worked advised on the privatisation of AsiaSat. Eric shared the information with Betty and Patsy. Betty and Patsy (acting for herself and Stella) then purchased shares in AsiaSat and afterwards sold the shares at a profit upon privatisation.

As for Betty, the SFC claimed that whilst on secondment to a bank, she obtained CMPSI about a tender offer that the bank intended to make for Hsinchu. Betty then shared the information with Eric and both acquired Hsinchu shares through an account opened in the name of Patsy. Patsy also invested on her own account and on behalf of Stella. Patsy and Stella accepted the offer at a substantial premium to the market price, making a profit for all involved. The total profit from the impugned transactions was HK$2.9 million.

In January 2016, the CFI found that Betty, Eric and Patsy had contravened section 300 SFO by engaging in fraud or deception in transactions involving Hsinchu shares, and section 291 SFO by insider dealing in AsiaSat shares,

and should disgorge their profits to their employers. While the CFI found that Stella did not contravene section 300, she was involved in the contravention and so was also liable to return her profits.

Eric, Patsy and Stella took their case to the Court of Appeal, which affirmed the decision of the lower court in November 2017.

COURT OF FINAL APPEAL

The central question for the CFA in *Securities and Futures Commission v Young Bik Fung* [2018] HKCFA 45 was the construction of section 300: (i) whether the word "*transaction*" in the context of section 300 should be widely interpreted to include conduct which took place before the purchase and shares of securities; and (ii) whether any fraudulent or deceptive acts occurred "*in a transaction involving securities*".

Section 300 provides that:

(1) A person shall not, directly or indirectly, in a transaction involving securities, futures contracts or leveraged foreign exchange trading –

> *(a) employ any device, scheme or artifice with intent to defraud or deceive; or*
>
> *(b) engage in any act, practice or course of business which is fraudulent or deceptive, or would operate as a fraud or deception.*

(2) A person who contravenes subsection (1) commits an offence.

(3) In this section, a reference to a transaction includes an offer and an invitation (however expressed).

The Court held that the word "*transaction*" should be interpreted by the context and purpose of the section and should be given a wide meaning to encompass the whole enterprise. Here, it included a series of purchases and sales of Hsinchu shares together with the steps that were taken with a view to making a profit or avoiding a loss by the misuse of inside information, such as the opening of a securities trading account and the giving of trading instructions to intermediaries.

THE "COUNTERPARTY" ARGUMENT

The appellants argued that, in order for their conduct to be regarded as occurring "*in a transaction involving securities*", the fraud must have been practised on the counterparty of either the purchase or the sale of the securities. Counsel for the appellants argued that when the shares were purchased, the vendors of the Hsinchu Bank shares were not defrauded.

The CFA found the argument to be unfounded. In the words of Mr Justice Ribeiro PJ, "*There is no requirement that the defendants be parties [to the "transaction"] as long as their fraudulent or deceptive scheme or course of business is employed in connection with or in relation to the transaction*". Mr Justice Tang PJ, delivering the main CFA judgment, concurred with this reasoning, citing the legislative history of section 300, a previous version of which had expressly referred to a "*transaction with any other person*" (original emphasis).

JURISDICTIONAL ARGUMENT

The case is novel because the express statutory insider trading provisions (sections 270 and 291 SFO) only apply to Hong Kong listed stocks (and so would not apply to the Taiwan-listed Hsinchu shares). Before this case, the

SFC had never used section 300 SFO to tackle insider dealing in overseas stocks, although it did discipline a licensed representative for trading a Japanese stock whilst in possession of inside information (see the *SFC disciplinary decision regarding Stephane Hug*, 13 December 2006).

Citing previous authority, including *HKSAR v Du Jun* [2012] 6 HKC 119, Mr Justice Tang PJ said he was *"of the view that conduct which would have amounted to insider dealing, but for the fact that the shares were not listed in Hong Kong, should be regarded as a crime, a species of fraud or cheating",* adding that *"I think it would be in keeping with the purpose of the SFO and Hong Kong's position as an international financial center, that provided 'substantial activities constituting the crime' occurred within Hong Kong, s 300 should cover the insider dealing in shares listed in Taiwan.*"

This case also revealed that the Hong Kong anti-fraud provision had actually been adopted from the SEC Rule 10b-5 in the 1970s and that in 1997, the US Supreme Court in *US v O'Hagan* 521 U.S. 642 (1997) had ruled that a law firm partner had committed insider trading by misappropriating confidential information acquired during his employment, in breach of his duties owed to his employer.

REMEDIES

As for the appropriate remedies, in previous market manipulation and insider dealing cases, upon application by the SFC, market manipulators and insider dealers had been ordered to disgorge their trading profits to the counterparties of the trades.

In this case, however, both the CFI and CA had espoused what was termed the *"misappropriation theory*" set out by the majority in *O'Hagan*, that a fiduciary who misuses inside information for gain or avoidance of loss has dishonestly misappropriated that information, which in itself makes the conduct fraudulent. The CFA also agreed that the victims of the defendants' insider dealing were their former employers in Hong Kong.

WIDER APPLICATION

The case represents the first time the courts in Hong Kong have formally recognised that the previously little used anti-fraud provision in Hong Kong securities law was an adoption of Rule 10b-5, more than forty years after its enactment in Hong Kong.

The majority of the CFA held that conduct which constitutes an offence of insider dealing under section 291 should be prosecuted under Division 2 of the SFO to the exclusion of section 300 and that section 300 should not be labelled as a *"catch all"* provision. It will be particularly interesting to see how this anti-fraud provision can be used for other types of securities misconduct, for example, corporate mismanagement of publicly listed corporations, something that would chime with the SFC's publicly stated enforcement priorities.

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