

## Updating Your Study Manual

### Instructions for Inserting Version 1.9

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The followings serve as the instructions for updating **Topic 9: Market Misconduct, Improper Trading Practices and Compliance** of Study Manual 1 for the Licensing Examination for Securities and Futures Intermediaries. Please be reminded that only the updated sections are provided for downloading. You may replace the relevant sections with this updated version for the study manual you possess.

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#### **Instructions:**

1. Download and print out the following pages.
  2. **Remove** pages 9-5 to 9-6            and            **Insert** new pages 9-5 to 9-6.
  3. **Remove** pages 9-11 to 9-12        and            **Insert** new pages 9-11 to 9-12.
  4. **Remove** pages 9-19 to 9-20        and            **Insert** new pages 9-19 to 9-20.
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- up to 10 years imprisonment and/or HK\$10 million on indictment and conviction; and/or
- up to 3 years imprisonment and/or HK\$1 million on summary conviction; and
- in addition the court may impose a disqualification order, a ‘cold shoulder’ order or a disciplinary referral order on conviction.

***Private civil actions and ensuing liability***

1.9 These are provided under s.281 (Part XIII) and s.305 (Part XIV) and include:

- the right of the affected person to sue for financial loss, available even if there are no MMT hearings, criminal actions or convictions involving the target person;
- the right to use MMT evidence in bringing such an action; and
- injunctions as an available remedy.

The statutory right of action does not affect or limit any common law rights or liabilities.

**Transitional applications**

1.10 Insider dealing that has taken place in whole or in part before the implementation of the SFO (discovered after 1 April 2003) will be handled under the Securities (Insider Dealing) Ordinance and before the Insider Dealing Tribunal which will be preserved to hear such cases.

**2 Definition of market misconduct in the SFO**

2.1 In this topic we shall consider market misconduct as defined in the SFO as well as other malpractices that may have the lesser impact of adversely affecting the fitness and properness of an intermediary or its staff. Market misconduct is identified in roughly the same way in Parts XIII and XIV, SFO to include:

- insider dealing;
- false trading;
- price rigging;

- disclosure of information about prohibited transactions;
- disclosure of false or misleading information inducing transactions; and
- stock market manipulation.

2.2 Part XIV specifies 3 additional types of offences that are not specified in Part XIII:

- fraudulent or deceptive acts or the use of fraudulent or deceptive devices in Type 1, 2 and 3 regulated activities (s.300);
- disclosure of false or misleading information inducing others to enter into LFE contracts (s.301); and
- falsely representing that a person has dealt in futures contracts on behalf of another (s.302).

### **3 Insider dealing (Division 4, Part XIII and Division 2, Part XIV, SFO)**

3.1 Two definitions have to be referred to in explaining what is insider dealing under the SFO:

*Relevant information* is specific information:

- in relation to a corporation, its shareholders or officers or its listed securities or their derivatives;
- which is not generally known to the persons who are accustomed or would be likely to deal in its listed securities; but
- if it were generally known to them,
- would be likely to materially affect the price of the securities.

*Connected persons* include:

- directors, employees or substantial shareholders (those holding at least 5% of nominal value of the shares for the purpose of insider dealing) of a corporation and its related corporation;
- persons who have access to relevant information by reason of having a professional or business relationship with the corporation or related corporation; and

## **7 Disclosure of information about prohibited transactions (ss.276 and 297, SFO)**

- 7.1 If a person who is a party to a prohibited transaction or has received a benefit from such an act discloses, circulates or disseminates information about the transaction and its effect on prices of securities or futures contracts, he will have engaged in market misconduct.
- 7.2 It is a defence for the person to show that he acted in good faith or did not receive a benefit from the party to the market misconduct or his associate.

## **8 Disclosure of false or misleading information (ss.277 and 298, SFO)**

- 8.1 If a person makes or is concerned with the intentional, reckless or negligent disclosure, circulation or dissemination of false or misleading information as to a material fact or its omission, which is likely to induce the subscription, sale or purchase of securities or dealing in futures contracts, or to increase, reduce, or maintain or stabilize their prices, then he is engaged in market misconduct.
- 8.2 If the act is intentional, reckless or *negligent* then it is misconduct under Part XIII (potentially giving rise to civil proceedings); if it is intentional or reckless, it is misconduct under Parts XIII and XIV (potentially giving rise to civil or criminal proceedings).
- 8.3 The person will not be considered to have engaged in market misconduct if he transmitted or re-transmitted the information, acting as a conduit, in good faith, as in the case of printers and publishers, in live broadcasts and so on in the ordinary course of business.

## **9 Conduct not to constitute market misconduct (Safe Harbour Rules) (ss.282 and 306, SFO)**

- 9.1 The SFC is empowered to make rules that exclude any acts defined as market misconduct under Parts XIII and XIV from the definition. The SFC has made the Securities and Futures (Price Stabilizing) Rules under these provisions to

permit and regulate price stabilizing action by issuers or underwriters in regard to public offerings.

## **10 Fraud and deception (s.300, SFO)**

10.1 A person who, directly or indirectly:

- employs any device, scheme or plan with the intention of committing fraud or deception; or
- engages in any fraudulent or deceptive act

in a transaction involving securities, futures contracts or LFET commits an offence.

Ss.301 and 302, SFO specify offences relating to LFET and futures contracts respectively. Students will not be tested on these two sections.

Revision questions:

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Question 4: Is there a difference between false trading and price rigging?

Question 5: State some elements of stock market manipulation.

Question 6: What is the offence of disclosing false and misleading information?

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## **11 Some improper trading practices**

11.1 We have studied the provision of the SFO regarding market misconduct. We shall now look at some unethical practices and market malpractices some of which fit into one or other of the categories examined so far and others that do not. Some of these may be captured under the SFO as subject to civil proceedings or criminal prosecution. All of them unless specified otherwise may breach the provisions of the Codes of Conduct and may impact on the fitness and properness of the intermediaries and their staff, who may be involved, to hold a licence.

- good corporate governance.

### **Corporate governance, the duties of directors and the interests of minority shareholders**

14.5 This is an area which is currently the focus of much attention in Hong Kong as well as internationally and with which intermediaries should be familiar in relation to their own position as corporations, the fact that regulated activities concern listed corporations, the impact of corporate governance and ‘mis-governance’ issues on their clients and the market and the increasing concern of the regulators with the related issues.

#### *Definition, objectives and structures*

14.6 Corporate governance has been simply defined as the system by which business corporations are directed and controlled. It has also been said to involve the relationships between a company’s management, its Board, its shareholders and stakeholders. Stakeholders include all groups who have a stake in the healthy existence of a corporation including all those mentioned above and employees, creditors and its customers. The Organisation for Economic Co-operation and Development (‘OECD’) has given a set of core principles of corporate governance practices to include fairness, transparency, accountability and responsibility.

14.7 One of the key objectives of good corporate governance in any corporate business is to avoid any one person or groups of persons acting in such a manner as to disadvantage one or more other groups or to favour the interests of one person or group over and above those of others. Hence most stakeholders in a corporation are interested in its good corporate governance.

14.8 Possible ways suggested for achieving this objective are to:

- install checks and balances such as separation of functions between the chairman and the CEO, non-executive directors (who may loosely be described as independent watchdogs ensuring proper corporate governance), audit committees (which will be independent and deal with appointments of auditors and audit issues), independent and strong audit functions, and remuneration committees (the last to control remuneration and benefits of directors and senior management in particular);
- increase transparency and disclosure to shareholders, stakeholders and the public;
- adopt international accounting and auditing standards (this is already being done in Hong Kong);
- install strong protective structures for minority shareholders, creditors and other lenders;

- identify and penalize corporate wrongdoings; and
- install a strong regulatory structure operated by a strong independent regulator.

The above actions should not hinder the efficiency of the business operations.

***Some of the effects of deficiencies in corporate governance***

14.9 Deficiencies in corporate governance standards are believed to have resulted in:

- insider dealing (refer to section 3 above);
- fraud, misfeasance and misconduct by directors and managers aimed at benefiting themselves and as a result causing loss to corporations or their members; and
- connected transactions where transfers of assets or lucrative parts of the business are made to other connected parties and the opposite where assets or businesses are acquired at a premium from a connected seller effectively to the detriment of minority shareholders in each case.

***Duties of directors and the interests of minority shareholders***

14.10 Refer to:

- paragraphs 2.41 and 2.42, topic 2 for the duties of directors; and
- paragraphs 2.32, 2.33 and 2.51, topic 2 for the protection of minority shareholders.

***Code on Corporate Governance Practices etc.***

14.10A [The Code on Corporate Governance Practices and the Rules on the Corporate Governance Report have been adopted into the Listing Rules \(and the GEM Rules\). These additions set out the views of the Exchange as to good corporate governance.](#)

**Internal organization**

14.11 The internal organization must be based on:

- proper segregation of duties;
- independence and delegation of authority to the internal audit, compliance and risk management functions with direct access to the Board;
- comprehensive manuals and procedures covering all operations and controls including the key functions and the safeguarding of clients assets and money;
- appropriate review procedures which should be spelt out in manuals and procedures for operations and compliance and be adhered to: