

# False Trading: Are Wash Trades and Matched Orders Now Illegal?

*A recent decision of the Court of Appeal opens up the possibility that market participants crossing securities with themselves or their affiliates in the market may be regarded as engaging in market manipulation. In this article, we review the Court of Appeal's reasons for judgment and assess its impact.*

The decision of the Court of Appeal in *HKSAR v Fu Kor Kuen* (CACC 179 of 2010, December 23, 2010) suggests that wash trades and matched trades are inherently manipulative and may undermine a statutory defence which is critical to legitimizing such trades. If this is correct, the decision is highly unsatisfactory, leaving market participants who engage in wash trades and matched orders for legitimate and non-manipulative commercial reasons potentially open to criminal prosecution.

## Statutory Background

In Hong Kong, the Securities and Futures Ordinance (“SFO”) creates a number of market manipulation offences, including false trading. The penalties are harsh – on indictment, a person guilty of false trading may be imprisoned for 10 years and fined HK\$10 million – and the courts are increasingly willing to hand down significant prison terms.

### Elements of False Trading

In simplified terms, under the SFO, false trading occurs where a person does anything with the intention that, or being reckless as to whether, it has or is likely to have the the effect of:

- creating a false or misleading appearance of active trading in securities traded on an exchange; or

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For more information

Timothy Loh,  
Principal  
[tloh@timothyloh.com](mailto:tloh@timothyloh.com)  
Hong Kong: +852 2899.0179

Cindy Sze,  
Associate  
[csze@timothyloh.com](mailto:csze@timothyloh.com)  
Hong Kong: +852 2899.0176

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*\* Solicitor, England and Wales. Not admitted or registered as a lawyer in Hong Kong*

*It is not clear from the Court of Appeal's decision whether all wash trades and matched trades now inherently create a false or misleading appearance of active trading because it is difficult to see how such trades could ever reflect genuine forces of supply and demand.*

- creating a false or misleading appearance with respect to the market for, or the price for dealings in, securities traded on an exchange.

### Statutory Deeming Provision

The SFO then establishes a statutory deeming provision. This provision says, in simplified terms, that a person is regarded as engaged in false trading if he:

- enters into any transaction (“**wash trade**”) of sale or purchase of securities that does not involve a change in the beneficial ownership of them ;
- makes an offer (“**matched trade**”) to purchase securities at a price that is substantially the same as the price at which he knows that an associate has made an offer to sell the same or substantially the same number of them and vice-versa.

### Court of Appeal Decision

In *HKSAR v Fu Kor Kuen*, the defendants day traded derivative warrants, all issued by the same issuer, on the Stock Exchange of Hong Kong to profit from a rebate scheme. To do so, they placed buy and sell orders against each other at around the same price and time to generate substantial trading volume. This was because under the rebate scheme, so long as each of the two defendants' trade volume in the warrants reached a certain level, they would each receive a rebate from their own broker that would more than offset their transaction costs, resulting in an almost risk-free profit.

The prosecution claimed that as the defendants' trades dominated the market turnover, they intended to create a false and misleading appearance of active trading in

the warrants or were reckless as to whether it had or was likely to have that effect.

The District Court convicted both defendants for false trading. The defendants appealed and the Court of Appeal dismissed the appeal against conviction.

Whilst market observers may agree with the Court of Appeal's decision, the decision leaves some uncertainty and doubt as to the scope of the false trading offence in cases of wash trades and matched trades. It is not, for example, clear whether following the decision, a taxpayer who transfers securities from one of his companies to another of his companies for tax planning reasons is guilty of false trading.

### False or Misleading Appearance

The false trading offence refers to a false or misleading appearance of active trading or with respect to the market for, or the price for dealings in, securities or futures contract. The Court of Appeal held that the term “false or misleading appearance” seeks to ensure that the market reflects “the forces of genuine supply and demand”. It did not go on to explain what was meant by “genuine supply and demand”, simply affirming that because the two defendants traded with each other frequently and at the same price, their trades were not “real” and therefore their trades had the effect of creating “...a false or misleading appearance” of active trading.

It is not clear from the Court of Appeal's decision whether all wash trades and matched trades now inherently create a false or misleading appearance of active trading because it is difficult to see how such trades could ever reflect genuine forces of supply and demand.

*Where a person does something with the intention that, or being reckless as to whether, it has or is likely to have the effect of creating a false or misleading appearance of active trading does not mean that the person's commercial motive is to create a false or misleading appearance of active trading.*

## Statutory Defence

The Court of Appeal went on to find that the defendants could not avail themselves of a statutory defence. Under the SFO, in simplified terms, where a person is alleged to have engaged in false trading through a wash trade or a matched trade, it is a defence for the person to prove that the purpose of the wash trade or matched trade or, where there is more than one purpose, the purposes of the wash trade or matched trade did not include the purpose of creating a false or misleading appearance of active trading in securities or with respect to the market for, or the price for dealings in, securities.

### Availability of Defence

The Court of Appeal appears to have taken the view that the statutory defence only applies where the statutory deeming provision applies. As noted above, under the SFO, a person is regarded as engaging in false trading where a person enters into a wash trade or matched trade. This is so even if the wash trade or matched order does not in fact create a false or misleading appearance of active trading in securities or with respect to the market for, or the price for dealings in, securities.

In other words, the Court of Appeal seems to have determined that because the defendants engaged in false trading without reference to the statutory deeming provision, it was not necessary to consider the statutory defence. It is not clear that this is correct.

On its face, the SFO provides that the statutory defence is available where "a person is charged with an offence... in respect of a contravention of [the false trading provisions] taking place through the commission of [a wash trade or matched trade]". The SFO does not provide that the statutory defence is available where a person is deemed

to have contravened the false trading provisions as a result of a wash trade or matched trade.

### Meaning of Defence

The Court of Appeal did not consider whether a "purpose", which is the term used in the statutory defence, is the same as an "intention", which is the term used in the charging language. However, the Court of Appeal did conclude that a person intends a result where an act will almost certainly produce a result and he knows this. At the same time, it does not seem to have taken issue with the District Court, which does not seem to have differentiated between "purpose" and "intention".

Where a person does something with the intention that, or being reckless as to whether, it has or is likely to have the effect of creating a false or misleading appearance of active trading does not mean that the person's commercial motive is to create a false or misleading appearance of active trading. If the "purpose" under the statutory defence refers to the commercial motive, it is vital to distinguish between the two.

As in the example above, a taxpayer may, as part of a tax plan, transfer securities from one of his companies to another of his companies knowing full well that the transfer would increase trading volume without any genuine supply and demand. He clearly intended to increase trading volume because he knew that his transfer would increase trading volume. However, this does not mean that the purpose was to increase trading volume. His purpose was clearly to improve his tax position.

Having said that, in this case, the District Court held that the defendants ran the risk that they would be unable to exit the market at the end of each day and therefore,

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wanted to create an active liquid market. Consequently, it held that at least one of their purposes was to create a false or misleading appearance in active trading. Thus, the statutory defence was not available even though another purpose may have been to profit from the rebate scheme.

## Summary

The state of law following the Court of Appeal's judgment in *HKSAR v Fu Kor Kuen* is unsatisfactory. The decision opens up the possibility that wash trades and matches orders create a false or misleading appearance of active trading and hence, the possibility that such trades are criminal. At the same time, if that is the case, it appears to deny the possibility of a defence based upon the commercial motive for the wash trade or matched order.

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