

Market Manipulation: Safe Harbour for Wash Trades and Matched Orders Upheld

A recent decision of the Court of Final Appeal provides a safe harbour for market participants who engage in wash trades or matched orders for non-manipulative commercial reasons. Prior to the decision, market participants engaged in such trades could be found guilty on a criminal basis for false trading even if they engaged in such trades for tax, estate planning or other legitimate reasons.

The decision of the Court of Final Appeal in *Fu Kor Kuen v. HKSAR* (FACC No. 4 of 2011, May 24, 2012) clarifies the scope of the market manipulation offences under the Securities and Futures Ordinance (“SFO”) and, in reversing the Court of Appeal, gives comfort to market participants who engage in wash trades and matched orders for legitimate and non-manipulative commercial reasons that they are not engaged in market manipulation. At its core, the decision adopts the reasoning set out in our earlier critique of the Court of Appeal’s decision in *HKSAR v. Fu Kor Kuen* (see “False Trading: Are Wash Trades and Matched Orders Now Illegal?” published by us in February, 2011).

Statutory Background

The 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.

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[A] person is regarded as engaged in false trading if he enters into a wash trade or matched trade whether or not the wash trade or matched trade in fact has, or is likely to have, the effect 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.

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 effect of:

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

Under the SFO, there is a deeming provision which provides, 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; or
- makes an offer (“**matched trade**”) to purchase securities at a price that is substantially the same as the price at which he has made, or he knows that an associate has made, an offer to sell the same or substantially the same number of them and vice-versa.

The effect of the deeming provision is that a person is regarded as engaged in false trading if he enters into a wash trade or matched trade whether or not the wash trade or matched trade in fact has, or is likely to have, the effect 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.

Statutory defence

The SFO then establishes a statutory defence which, in simplified terms, provides that where a person is

charged with 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.

Court of Final Appeal Decision

In *HKSAR v Fu Kor Kuen and others*, 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 first bought derivative warrants from the issuer at an early stage of a trading day, then placed buy and sell orders repetitively against each other at around the same price during the trading day to generate substantial trading volume. This was because under the rebate scheme, the more trading volume the defendants generated, the more rebate they would receive from both the issuer and their own broker which would more than offset their trading transaction costs, resulting in an almost risk-free profit. Before the end of the same trading day, the defendants disposed of the derivative warrants, at around the same price they had bought them from the issuer at the beginning of the trading day, either to the issuer, a third party or a combination of the two.

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.

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Errors of the Court of Appeal

Consistent with our earlier article, the Court of Final Appeal found that the Court of Appeal erred in 2 respects:

- *Availability of Statutory Defence* - First, the Court of Appeal wrongly denied the defendants the use of the statutory defence which otherwise would have enabled them to defend the allegation of false trading on the basis that their trades did not have a manipulative purpose. The Court of Final Appeal affirmed in essence that where a person engages in a wash trade or a matched trade and is charged with false trading, he may defend the charge on the basis that the purpose of the wash trade or matched order 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. This is so even if the prosecution does not rely upon the statutory deeming provisions in respect of wash trades and matched trades.

- *Distinction Between Purpose and Intention* - Secondly, the Court of Appeal failed to distinguish between the purpose of the trades (*i.e.* the objective of the trades) and the intent of trading (*i.e.* the desire to cause certain market activity). In this respect, it was agreed that the objective of the defendants trading was to generate commission rebate income and was not manipulative in nature. Thus, the defendants were entitled to avail themselves of the statutory defence.

Rebuttable Presumption

The Court of Final Appeal went on to decide that the statutory deeming provisions are constitutional and that they establish a persuasive burden of proof to be discharged on a balance of probabilities. In other words, a person's constitutional right to be presumed innocent until proven guilty is not infringed because a person, who is proven beyond reasonable doubt to have engaged in a wash trade or matched trade, must prove, on a balance of probabilities, that he had no manipulative purpose.

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