Fraudulent and Deceptive Conduct: The Criminalization of Private Wrongs

Proceedings currently before Hong Kong courts will determine whether and how regulators can use anti-fraud provisions of the Securities and Futures Ordinance to sidestep the limitations of specific offence provisions. The ultimate effect of these proceedings may have far reaching and dramatic consequences by expanding the range of criminal wrongdoings well beyond the specific categories now contemplated by the law. In this article, the authors argue for an application of anti-fraud provisions consistent with longstanding policy rationale of protecting market integrity.

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The Court of Appeal ("**CA**") decision in Securities and Futures Commission ("**SFC**") v. Young Bik Fung confirmed that insider dealing as well as other market misconduct could be regulated under the anti-fraud provisions of s. 300 of the Securities and Futures Ordinance ("**SFO**"). Whilst the CA's finding against the defendants in this case seems the correct outcome in light of the mischief that insider dealing provisions are intended to address, the decision is troubling in its open-ended legal theory of liability. It appears that a breach of private law duties which involve transactions in securities may now be subject to criminal sanction, even where the breach results in no harm to the securities markets. However, with leave to appeal having been granted in a limited extent, it is to be hoped that the Court of Final Appeal ("**CFA**") will find liability in this case to arise instead on the basis of fraud or deception against the market.

Describing s. 300 of the SFO, which criminalizes fraudulent and deceptive acts, as a "general catchall provision" that "should be construed widely", the CA on November 9, 2017 upheld a finding of

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liability under this provision in place of another narrower offence provision that proved inapplicable. The decision raises a real concern as to the possible criminalization of conduct that may have no negative consequences for the investing public and that has until now been understood to remain a matter of private law between civil parties.

On March 6, 2018 the CA granted leave to appeal to the CFA on questions relating to the meaning of the phrase "in a transaction involving securities".

Applicable Law

Section 300(1) of the SFO provides as follows:

"A person shall not, directly or indirectly, in a transaction involving securities …

(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."

Background

The case concerns a young couple who, while working as lawyers, acquired confidential material price sensitive information about takeover proposals regarding two listed companies. With respect to one company, Hsinchu Bank, the couple conspired with the sister of one of them to purchase shares before a takeover offer by Standard Chartered Bank ("**SCB**"). It was a blatant example of insider dealing, except that the shares were listed in Taiwan, and thus fell outside the scope of the insider dealing offence at s. 291 of the SFO. As a result, the SFC sought civil remedies (including injunctions and remedial orders) under s. 213 relying upon a breach of s. 300.

The first defendant, Betty, acquired the insider information about Hsinchu Bank while seconded from her law firm, Slaughter & May ("**S&M**"), to SCB. In the week leading up to the announcement of the takeover offer, the defendants purchased HK$6,381,000 of shares through a new brokerage account set up by Patsy, the sister of Betty's boyfriend Eric. Patsy acquired the shares in her name for the three of them (and for another sister, Stella, in relation to whom the trial judge decided there was insufficient evidence that she was aware of the illicit enterprise). On accepting the takeover offer, they made a profit of around 44%, and immediately withdrew all funds from the account.

Decision

Amongst other things, the defendants argued that to be regarded as fraud or deception "in a transaction involving securities", the fraud or deception must be practised on the counterparties from whom the defendants bought the securities on the Taiwan Stock Exchange, and that this was not the case. The SFC appears not to have alleged that the defendants did indeed commit fraud or deception against those counterparties or the market more generally, and the judgment does not canvass that possibility.

Participants in the broader market presumably would not have sold the shares at the then market price had they known that the defendants had insider information indicating the price of the shares would soon increase considerably. As a result, it should have been possible to conclude that the defendants cheated the market generally by acting dishonestly for personal gain and that this amounted to engaging in an act which

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was fraudulent or deceptive. A decision on that basis would have been consistent with the policy rationale of insider dealing laws, which is that market integrity is undermined if insiders are able to trade with other market participants who are disadvantaged through asymmetry of information.

The Young Bik Fung decision, however, was not made on that basis. Instead, the CA accepted the SFC's allegation and the trial judge's finding that the party defrauded or deceived was SCB, and that the fraud or deception was Betty's misuse, in breach of her fiduciary duties, of confidential information that she obtained as a secondee to SCB. The SFC relied on several factors pointing to Betty's fiduciary duties to S&M and SCB:

- a duty of confidentiality in her employment contract with S&M;
- S&M's Dealing Rules, prohibiting disclosure or misuse of confidential information;
- an email from Betty acknowledging that she understood SCB's Memorandum on Inside Information, imposing a duty of confidence and prohibiting disclosure of inside information;
- the Solicitor's Guide to Professional Conduct, prohibiting a solicitor from making personal profit by using confidential information acquired in a professional relationship; and
- the common law duties of a person in a fiduciary position to act in good faith and not for his own benefit without the consent of his principal.

In explaining the detriment suffered by SCB, the trial judge stated that if SCB "had known the shares had been bought in breach of fiduciary duties owed to it by Betty, they would obviously have refused to pay out to her and her tippees." In our view this assumption is erroneous, given SCB's objective of acquiring 100% of the Hsinchu Bank shares, including the defendants' proportionately negligible shareholdings. In other words, the CA used one relatively inconsequential mischief (a breach of fiduciary duties) to establish a remedy for the real one (the insider dealing). This opens a pathway to liability on a policy basis unrelated to that for the real crime.

Although in this case the party supposedly defrauded in the transaction was the party to whom Betty owed the fiduciary duty (SCB), the judgment also states, "s300 itself does not in terms require that the fraud or deception must be directed at the parties to the sale or purchase of the securities. Further, the prefacing words 'directly or indirectly' in s300 make it clear that the fraud or deception need not be part of the transaction itself. Hence, as a matter of construction of s300, it is open for liability to be established under s300 based on fraud or deception practised upon a person other than the counterparty directly engaged in the transaction."

By this reasoning, a fraud or deception under s. 300 might not impact the market price or undermine market integrity. Indeed, that was so in this case, where the CA found that the fraud was not the defendants' purchase of the shares on the market, but their acceptance of the takeover offer.

Consequences

Assigning culpability under s. 300 merely on the basis of a fraud or deception that has no effect on the market generally is an extraordinary extension of securities laws which we believe should be reversed on appeal. There is no obvious basis to invoke securities laws in

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circumstances where the securities markets are not harmed.

Take, for example, a private off-market transaction in unlisted securities between two individuals. One of the individuals deceives the other in the transaction, perhaps by misrepresenting some fundamental aspect of the issuer of the securities. Based on the decision of the CA, it appears that this individual could be found liable for a breach of s. 300 even though the transaction has no effect on the wider market.

Equally, for example, take a brokerage firm which requires that employees obtain prior approval for personal dealings in securities. Based on the decision of the CA, it appears that an employee could be prosecuted for a breach of s. 300 if he traded for his own account without obtaining prior approval, thereby deceiving his employer. This could be the case even if the trade was not motivated by any inside information or other confidential information and was fully compliant with the SFO. Without any fraud or deception on the market, the wrongdoing would simply be the employee's breach of fiduciary duties and of the employer's internal conduct requirements. Whilst conviction on that basis would be an astonishing result, an aggressive application of the Young Bik Fung precedent would appear to enable it.

The defendants in this case alluded to a danger of s. 300 being used to bypass proper statutory constraints on prosecutorial powers. As the CA summarized the submission, "the court should not construe s300 as being available for prosecution of insider dealing as it would deprive those prosecuted of the benefit of the specific statutory defences." Those defences include situations, for example, where an insider deals in listed securities in the performance in good faith of an underwriting agreement, or for the sole purpose of acquiring shares required for his being qualified as a director, or where the insider can prove that the purpose of dealing in the listed securities was not to secure a profit or reduce a loss.

However, the CA rejected this argument, stating, "if there were elements of fraud or deception arising not from misuse of insider information, there is no sound rationale for affording a defence to a prosecution under s300. … For insider dealings, there is no risk of s300 being applied in an oppressive manner…. We are not satisfied that simply because of these specific defences in s292 [to insider dealing offences], we should construe s300 in a way to exclude its application to transactions of insider dealings."

As s. 300 on its face does not exempt activities which otherwise would fall within the statutory safe harbours, it would appear that a person may be convicted of an offence under s. 300 for activities that the specific defences are designed to ensure are permissible. It may be suggested that such activities would not constitute fraud or deception, but the basis upon which such a view could be reached is unclear, given the broad interpretation that the CA considered should be afforded under s. 300.

The issue of proper limits on powers also arose in relation to s. 213, under which the trial judge made a restitution order compelling return of profits by Stella despite no finding of wrongdoing by her. The CA observed, "the SFO recognizes that the very breadth of the power could result in unfairness of its application" and hence includes a constraint in its subsection (4) that the court must "satisfy itself … that it is desirable that the order be made, and that the order will not unfairly prejudice any person."

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Conversely, there is no defence, limitation or exemption in the language of s300. This leaves broad scope for prosecutors to commence proceedings, and considerable latitude for courts in determining the outcome. This is a concern, as one might argue whether it is true that there is no danger in Hong Kong of the criminal law being applied in an oppressive manner.

Appeal

The CA has granted leave to appeal its decision that the phrase "transaction involving securities" in s. 300 should be given a wide interpretation and construed purposively to cover the whole deceptive scheme or the whole course of dealings. This appears to give sufficient flexibility for the CFA to attach liability for wrongs to the market as a whole, rather than to particular individuals or organizations (in this case, SCB).

In the end, whilst it may well be desirable for s. 300 to serve as a catch-all provision that fills any gaps in the statutory framework elsewhere in the SFO, the basis upon which it does so deserves careful attention to ensure that there is a clear link between liability under s. 300 and the policy outcomes which the SFO is intended to achieve. Regrettably, in our view, the CA decision fails to provide that link, resulting in a real risk that the SFO will be applied to impose criminal liability for breaches of conduct requirements that have hitherto been mere standards of conduct as between private individuals dealing with each other. There is now an opportunity for the CFA to decide the case on grounds more consistent with the traditional basis of liability for insider dealing.

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