

## Client Alert

October 2018

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## Court of Final Appeal clarifies innocent purpose defence to insider dealing

In *Securities and Futures Commission v Yiu Hoi Ying Charles and Others* (FACV5/2018), the Court of Final Appeal (CFA) handed down a landmark decision on the innocent purpose defence under section 271(3) of the Securities and Futures Ordinance (SFO). The CFA ruled that the respondents "used" the price sensitive information (PSI) when they sold the securities, knowing the prices were artificially high because the PSI was not generally known to those accustomed or likely to deal in the securities.

In 2007, a debt owed by Asia TeleMedia Limited (ATML) was assigned to a new creditor and the new creditor served a statutory demand on ATML for \$70.27 million. ATML did not announce this PSI to the public. Two senior officers (the "Respondents" before the CFA) of ATML with knowledge of the developments dealt in the shares of ATML. The Respondents subjectively believed that whatever threatened the share price would be resolved "behind closed doors" and would not become a matter to influence the market. The Market Misconduct Tribunal (MMT) held that the Respondents had not "used" the PSI. The Respondents were merely seizing an unexpected speculative surge in the share price and the PSI had played no part in their decisions, the dealings were defensible by the innocent purpose defence under section 271(3) of the SFO. The MMT's decision was upheld by the Court of Appeal (CA) in April 2017.<sup>1</sup>

The CFA, by a majority of four to one (Tang PJ dissenting), disagreed with the MMT's application of the innocent purpose defence and the CA decision.

Our alert discusses the implications of the CFA's decision and its significances to officers who deal with PSI and parties who invest in listed companies.

### What is the innocent purpose defence?

Section 271(3) of the SFO provides that a person shall not be regarded as having engaged in market misconduct by reason of an insider dealing if he establishes that the purpose(s) for which he dealt in the listed securities did not include the purpose of securing or increasing a profit or avoiding or reducing a loss, by using PSI.

### The CFA decision

The majority of the CFA found that the Respondents had, as a matter of law, failed to make good the innocent purpose defence.

Construing section 271(3) purposively, the CFA held that "using" the PSI means making one's decision to buy or sell the listed securities because of the quoted market price, knowing that price to be either artificially high or artificially low because the PSI is not generally known to those accustomed or

<sup>1</sup> Please see our [client alert dated September 2017](#) discussing the CA decision and our article in the Spring 2016 issue of [Momentum, magazine of the Chamber of Hong Kong Listed Companies](#), discussing the MMT decision dated 26 November 2015





likely to deal in the securities. The statutory purpose of prohibiting insider dealing is to prevent the mischief of an insider taking advantage of PSI to steal a march on the rest of the market. The CFA noted that that the insider relying on this defence was generally expected to positively establish an innocent purpose, such as the trade being carried out pursuant to contractual obligations or a Court order. Mere withholding or non-disclosure of the PSI does not constitute "use". It is the turning of the possession of that knowledge into action which constitutes the "use" of such PSI.

The CFA concluded that the Respondents' share dealings plainly involved "using" the PSI. They took advantage of their knowledge and secured profits which were significantly greater than they ought to have been if the PSI was disclosed to the market.

Apart from clarifying what constitutes "use", the CFA also held that the Respondents' subjective belief that the creditor's demands would be resolved behind closed doors was irrelevant. An insider may still "use" PSI while believing that the information would not be leaked. Further, an insider "uses" the PSI at the time of dealing which is the relevant time. The insider's belief as to a prospective resolution in the future is irrelevant. The CFA remarked that it would be surprising if the law were to permit an insider to escape culpability by reliance on an subjective belief that the market would never find out the PSI.

The CFA remitted the matter to the MMT to deal with the question of sanctions.

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## Implications of the CFA decision and practical tips

The CFA explicitly stated that the innocent purpose defence is not easy to establish. The CFA's narrow interpretation of the innocent purpose defence has significant implications. The decision provides useful guidance for directors, senior officers, shareholders and potential investors of listed companies who intend to rely on the innocent purpose defence.

We recommend that they take note of the following when handling PSI and dealing in listed securities:

- They should adopt a cautious approach in handling PSI. For the directors and senior officers, they should ensure that PSI is disclosed as soon as reasonably practicable.
- They should seek legal advice if they intend to deal in the relevant listed securities while possessing PSI on the belief that one or more of the statutory defences to insider dealing may be made out.
- They should conduct an evaluation of whether they are in possession of any PSI before dealing in the relevant listed securities.
- If they intend to rely on the innocent purpose defence, they should ensure that the intended purpose falls within the narrow definition set out by the CFA and that all relevant matters are properly documented.
- They should familiarise themselves with the relevant SFC Guidelines on the handling of PSI and attend appropriate trainings to ensure their knowledge is up-to-date.
- If there is any doubt, they should seek legal advice.