

Linklaters

Client Briefing – Court of Final Appeal overturns application of “no profit motive” defence in insider dealing case



The Hong Kong Court of Final Appeal (“**CFA**”) has allowed an appeal by the Securities and Futures Commission (“**SFC**”) against the findings of the Court of Appeal that two former executives of Asia Telemedia Limited (“**ATML**”) had not engaged in insider dealing in ATML shares because of the successful application of the “*no profit motive*” defence to insider dealing under section 271(3) of the Securities and Futures Ordinance (“**SFO**”). In allowing the appeal the CFA held that the Market Misconduct Tribunal (“**MMT**”) ought to have held that the respondents failed to make good the defence under section 271(3).

In *The Securities and Futures Commission v. Yiu Hoi Ying Charles, Wong Nam Marian and the Market Misconduct Tribunal* [FACV No.5 of 2018], the CFA provided clarification on the innocent purpose defence in insider dealing cases under section 271(3). The CFA found, by a majority of four to one, that the MMT had “erroneously” acquitted the respondents of market misconduct and remitted the matter back to the MMT to deal with the question of sanctions.

Background

The case concerned a Hong Kong listed company then known as ATML, which was heavily indebted to its controlling shareholder and therefore insolvent. ATML defaulted in its repayments to the controlling shareholder, which led to her serving five statutory demands on ATML between October 2002 and April 2006. However, on each occasion, the controlling shareholder had entered negotiations, which resulted in no winding-up petition being served.

2005

In 2005, ATML had granted stock options to employees including the respondents, exercisable at \$0.20 per share.

2007

On 1 February 2007 the controlling shareholder’s debt was assigned to a company called Goodpine Limited. Four days later, Goodpine’s solicitors demanded repayment of the debt in full and threatened legal proceedings. On 26 April 2007, Goodpine’s solicitors served a statutory demand for payment of HK\$709 million. On 6 June 2007, Goodpine served a winding-up petition on ATML and trading in its shares were suspended from 7 June 2007. These events were not announced. Between February and May 2007, ATML’s share price experienced a surge from HK\$0.20 to HK\$0.97. The respondents had exercised their share options by selling shares during the course of the surge between February and June 2007 and each made a profit. This was during a time when each of the respondents was knew of the threatened and unannounced winding-up proceedings. Shortly afterwards, on 15 June 2007, ATML announced that it had been served with a winding-up petition. When trading resumed on 18 October 2007, ATML’s share price closed at HK\$0.315, representing a 62% drop from the closing price of HK\$0.83 on 6 June 2007. On the basis of these events, insider dealing proceedings were brought against the respondents.

The respondents’ evidence was that they had surmised that Goodpine was the controlling shareholder in another guise and that they thought that they would be able to negotiate this matter ‘behind closed doors’ such that the matter would never enter the public domain (the “behind closed doors” defence), as they had done on previous occasions.

Before the MMT, the respondents raised the ‘innocent purpose defence’ under section 271(3). The defence comes into play where a prima facie case of market misconduct has been established and where the person relying on the defence can establish that the purpose for which he or she dealt with the securities was not and did not include the purpose of securing or increasing a profit by using inside information. The MMT found that the insider dealing was established against the respondents, but that they had successfully brought themselves within the innocent purpose defence under section 271(3), because their motive in selling was to secure a profit from the unexpected speculative boom in the price of ATML shares, not by reason of the information they had about ATML’s indebtedness to Goodpine that they thought would be sorted out “behind closed doors”. The MMT, therefore, acquitted them of market misconduct. The SFC then unsuccessfully appealed to the Court of Appeal (considered in detail [here](#)), and then successfully appealed to the CFA.

The central question in the appeal to the CFA was whether, on the MMT’s findings, the respondents were able, as a matter of law, to rely on the innocent purpose defence under section 271(3).

Conclusion

The CFA found that the MMT had erred in law in holding that the “behind closed doors” justification was capable of assisting the respondents to establish the section 271(3) defence and that the respondents share dealings had plainly involved “using” the inside information. The respondents sold their shares taking advantage of their knowledge that the prices and profits they were securing were significantly greater than they ought to have been, and which would not have been achievable if the information were to be available in the market.

The CFA made the point that a section 271(3) defence is not easy to establish. It only arises after a prima facie case of insider dealing is established. Normally, a finding that parties dealt with relevant shares while in possession of information which they knew was price sensitive, supports an inference that their purpose was or included the purpose of making a profit or avoiding a loss by using the price sensitive information. A section 271(3) defence is not easy to establish and generally the insider would be expected to positively establish an innocent purpose. This puts insiders at a disadvantage compared to others who may deal in the securities, but that is a consequence of being a connected person who comes into possession of price sensitive information.

For those considering whether the defence may now be of any practical application, the CFA decision offers limited scope. It commented that the defence may arise where the dealing arises from a prior contractual obligation that required a sale whether or not it realised a profit or a loss, or the shares are sold in compliance with a court order, for instance in matrimonial financial relief proceedings.

The full judgment is available [here](#).

Key contacts



Melvin Sng
Head of Dispute Resolution, Asia
Tel: +852 2901 5234
melvin.sng@linklaters.com



Gavin Lewis
Partner
Tel: +852 2901 5388
gavin.lewis@linklaters.com



Andrew Chung
Partner
Tel: +852 2901 5238
andrew.chung@linklaters.com



Denise Fung
Partner
Tel: +852 2901 5012
denise.fung@linklaters.com

linklaters.com

