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Wall-crossing in Hong Kong: Risk Management Issues

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In the UK, there has recently been significant media coverage of market abuse in the context of "wall-crossing", the process by which a securities offering is selectively pre-marketed to potential investors before the deal is publicly announced. The UK Financial Services Authority ("**FSA**") has stepped up enforcement on market participants for breaching the market abuse regime under section 118 of the UK's Financial Services and Markets Act 2000 ("**FSMA**") by inappropriately disclosing or trading on inside information in this context.

In Hong Kong, what are the parameters for such activities, and how will the Securities and Futures Commission ("**SFC**") and the Market Misconduct Tribunal (the "**Tribunal**") approach them? The position became clearer in late May 2012, with two Tribunal decisions that offer guidance on information that will fall within the insider dealing regime, the imputing of knowledge to recipients, the regulatory reach of the SFC, and hence protective measures that companies and other market participants should take.

Whilst market conditions remain volatile, wall-crossing activities are increasing among public companies and financial institutions seeking to build a solid base of investors prior to offering equities to the public. Market participants in Hong Kong should be mindful that this activity is likely to be subject to increasing regulatory attention.

OVERVIEW OF THE HONG KONG REGIME

Wall-crossing in Hong Kong is subject to the insider dealing provisions of the Securities and Futures Ordinance (the "**SFO**").

Under the insider dealing provisions, where a person (i) has information which he knows is **relevant information** in relation to that listed corporation, and (ii) is **connected** with that listed corporation, or received the information (directly or indirectly) from a person whom he knows is so connected and whom he knows (or has reasonable cause to believe) held the information as a result of being so connected, that person should not **deal**, or **counsel** or **procure** another to deal, or **disclose information** to another person knowing or having reasonable cause to believe that such other person will make use of the information for the purpose of dealing, or of counseling or procuring another person to deal, in the securities of the Hong Kong listed corporation (or a related corporation) or their derivatives. The key elements of these restrictions and their implications are considered further below.

Relevant Information

Inside information, defined under the SFO as "relevant information", is information that is not generally known, and is material and specific. The term means information about a corporation, or a shareholder or officer of the corporation, or about the listed securities of the corporation or their derivatives. It only applies where such information is **not generally**

known to those persons who are accustomed or would be likely to deal in the listed securities of that corporation. What is "**material**" information is a question of fact, to be assessed on the basis of how general investors would have acted on the date when the dealing took place, if they had known the relevant information.

The Tribunal has recently cast light on what constitutes "**specific**" information for these purposes. In the latest case regarding Chaoda Modern Agriculture (considered further below), it stated that it is not necessary that "all the particulars or details of the transaction, event or matter be precisely known", but that there is "substantial commercial reality" in the event occurring.[1]

The FSA also provided useful guidance on the application of the requirement for "specific" information in the context of wall-crossing, in the latest UK case which related to a hedge fund manager, David Einhorn (the "**Einhorn Case**"). In that case, Mr. Einhorn and his fund, Greenlight Capital, were fined a total of £7.2 million for shorting shares of Punch Taverns ("**Punch**") on the basis of inside information disclosed to Mr. Einhorn about a proposed equity issuance by Punch, notwithstanding that prior to receiving the information Mr. Einhorn had declined to be wall-crossed or to sign a confidentiality agreement. The regulatory test in the UK is, among other factors, that the information be "precise" because it indicates existing or likely circumstances and is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances (section 118 FSMA). In the Einhorn Case, the information disclosed included the approximate amount and the purpose of the possible issuance, that any non-disclosure agreement would last less than one week, that the issuer had been consulting with all major shareholders, and that there was broad support from those who had signed non-disclosure agreements. In considering whether the information in question satisfied the test under section 118 FSMA, the FSA took a "mosaic" approach and concluded that, even though taken in isolation no one piece of information would amount to inside information, taken together the information did constitute inside information because it effectively disclosed the anticipated size, purpose, and timing of the proposed transaction.

Connected

The SFO defines persons who are "**connected**" with a corporation in very broad terms, including among others (broadly, and in addition to group companies' directors, employees and substantial shareholders) any person who has access to relevant information concerning the corporation by reason of his being "connected" with another corporation, where the information relates to any **actual or contemplated transaction** involving both those corporations, or involving one of them and the listed securities of the other or their derivatives, or to the fact that such a transaction is no longer contemplated. Those who are wall-crossed in relation to a prospective transaction involving a listed corporation will typically be "connected" with it by virtue of receiving information from a person falling within this definition.

Dealing, Counseling or Procuring

The SFO's scope extends to a wide range of dealings in listed securities or their derivatives. A person "deals" in securities or their derivatives if (whether as principal or agent and whether on or off market) he buys, sells, exchanges or subscribes for listed securities or their derivatives or agrees to do so, or acquires or disposes of, or agrees to acquire or dispose of, the right to buy, sell, exchange or subscribe for any listed securities or their derivatives. [2] Insider dealing also

[1] Part I , The Report of the Market Misconduct Tribunal into dealings in the shares of Chaoda Modern Agriculture (Holdings) Limited on and between 15 June 2009 and 17 June 2009

[2] Section 289 of the SFO.

takes place when a person with relevant information counsels or procures another to deal in listed securities or their derivatives[3].

RECENT SFC ENFORCEMENT ACTIONS

Extra Territorial Reach

Under the SFO, insider dealing is both a criminal offence and a form of civil market misconduct. Under the civil regime of the SFO, the Tribunal is empowered to impose various kinds of sanction, including disqualification orders (disqualification as director, liquidator, receiver or manager of listed companies, etc.), cold shoulder orders (ban on using the services of SFC licensees in acquiring, disposing of or dealing in securities or financial products for a period up to 5 years), and disciplinary referrals. Under the criminal regime of the SFO, a person who commits the insider dealing offence may be liable to a fine up to HK$10 million and to a maximum of 10 years' imprisonment.

In a landmark decision in February 2012, the Hong Kong Court of Appeal allowed an appeal by the SFC from the decision of a lower court and permitted the SFC to seek remedial orders and injunctions against Tiger Asia Management LLC ("**Tiger Asia**") without a pre-existing criminal conviction or determination by the Tribunal[4]. The SFC alleged that Tiger Asia and its officers contravened Hong Kong's insider dealing and market manipulation laws, by dealing in shares of Bank of China Limited ("**BOC**") and China Construction Bank Limited in 2009 on the basis of confidential and price-sensitive information received from the bankers arranging their respective placements. The SFC also alleged that in the BOC incident, Tiger Asia had agreed to be "wall-crossed".

The SFC succeeded in obtaining this judgment despite the fact that Tiger Asia is a New York-based fund manager which, though specializing in equity investments in China, Japan and Korea, has no physical presence in Hong Kong, all its employees being in New York. The implications are significant and far-reaching for any fund manager who trades in securities on The Stock Exchange of Hong Kong Limited (the "**Stock Exchange**"), wherever the fund manager may be located, as the SFC has dramatically shown its wide reach.

Latest Market Misconduct Tribunal Case: Chaoda Modern Agriculture

In April 2012, a US-based portfolio manager at Fidelity Management & Research Company was found culpable of insider dealing by the Tribunal. He was banned from dealing in securities in Hong Kong for two years and ordered to pay government and SFC costs of approximately US$110,000. It was found that "it was not a coincidence" that, on the very day on which the manager received material price-sensitive information during a telephone conference call with the management of Chaoda Modern Agriculture (Holdings) Limited ("**Chaoda**"), a listed company on the Stock Exchange, he placed an order to sell a parcel of those shares, hence avoiding a loss. He did not have to disgorge the loss avoided because the Tribunal found that the loss was avoided by the fund he managed, and not by him personally. However, in a sign of increasing international cooperation among regulatory authorities, the Tribunal invited the SFC to provide the SEC with its report so that the SEC may consider what, if any, action may be appropriate in the US.

The Tribunal accepted that the information was in effect 'dumped' on the Fidelity portfolio manager: no protocols had been invoked in respect of the telephone conference call (i.e. no opportunity was given to decide on being wall-crossed), nor was the manager alerted in any way that in fact he would be the recipient of non-public price-sensitive information about

[3] Section 291(1)(b) of the SFO.

[4] Leave has been granted for Tiger Asia to appeal to the Court of Final Appeal.

Chaoda. This resulted in his "being made vulnerable to the receipt, without prior warning let alone agreement, of non-public price sensitive information" from Chaoda's management.

However, the Tribunal was satisfied that the manager realized the market did not know of the material price-sensitive information that he had just received, and that he knew he was in possession of "relevant information" in respect of Chaoda.

This Tribunal decision makes clear that market participants should take care over wall-crossing protocols, and that the Tribunal will readily impute to them knowledge that information is "relevant information" based on the circumstances.

The decision (and the Hong Kong legislation) does not go as far as the UK test for insider dealing elucidated by the FSA in the Einhorn Case—namely whether the individuals *should have known* that they were dealing with inside information—but indicates a pragmatic approach to inferring actual knowledge. (In the Einhorn Case, the fact that Mr. Einhorn refused to be wall-crossed or to sign a non-disclosure agreement did not exonerate him from an obligation not to trade inappropriately on information which, despite his refusal, was nonetheless given to him and which as a highly experienced market professional, he should have known was insider information).

The Tribunal also warned in this decision that where 'experienced and seasoned' company insiders blatantly ignore protocols and 'dump' information on investors, they could be found culpable of insider dealing if they have "reasonable cause to believe that the other person will make use of the information for the purpose of dealing" in the shares of the company.

PRE-SOUNDING STRATEGIES

In January 2012, the Stock Exchange issued a Guide on Disclosure of Price Sensitive Information to help issuers and their directors fulfill their obligations under the listing rules. It suggested that **listed corporations should establish a communications policy and procedure** to assist the systematic dissemination of price-sensitive information. In the same connection, it is advisable that **investment banks and other market participants should establish their own procedures** to monitor the sharing of inside information in the context of wall crossing and pre-sounding. As further suggested in the Guide, the relevant parties should be **expressly told that they will be made 'insiders' prior to wall-crossing** and be reminded of the need to keep information strictly confidential. Dissemination of inside information should be limited to those who "need to know". Where appropriate and if in doubt, the market participant should seek professional legal advice. It is worth noting that in the Einhorn Case, Merrill Lynch was not sanctioned, whereas its employee who disclosed the information to Mr. Einhorn was fined a significant sum for the market abuse offence of improper disclosure. A solid internal compliance program will help to protect the organisation against "rogue" action by an employee in breach of internal rules.

Most banks and listed corporations have already implemented **internal information barriers** to restrict the flow of inside information ("**Chinese Walls**"). In addition, compliance should be enhanced by **regular training to staff**, to ensure that they understand their obligations and liabilities in respect of insider dealing and wall-crossing. Market participants can be accused of market misconduct even though no trading has taken place.

Moreover, SFC licensees risk being banned or otherwise sanctioned by the SFC under the licensing legislation if they fall foul of those (more demanding) standards. Such a case arose in January 2008, when a former licensed representative of a major bank was banned by the SFC for breaching Chinese Wall restrictions and taking "an undisciplined approach to confidential information", although his conduct did not actually result in any insider dealing activities by himself or others.

The SFC found that after he was "wall-crossed" by his employer in relation to a listed company, he disclosed information about the listed company to his colleagues in the equity sales department without authorization from his employer, and continued to recommend the listed company to his clients.

Additionally, as the recent cases noted above demonstrate, (i) **disclosing only partial deal particulars will not provide any protection**, as they can still be "relevant information"; and (ii) prior to bringing specific investors "over the wall" in connection with a possible transaction, bankers conducting the pre-sounding should, as part of their compliance procedures, insist on **entering into a confidentiality agreement** for the negotiation period until the inside information is made public. The confidentiality agreement should include prohibition not only of disclosing the information in question but also of trading the relevant securities. Target investors should also be **vetted by a bank's risk management staff** to avoid any conflicts of interest and to assess the potential exposure to risk before any wall-crossing activities proceed. Securities in respect of which inside information is received should generally be subject to a **trading freeze** until the information is announced publicly.

It is a key element of market participants' risk management to ensure that a conservative approach is adopted in connection with wall-crossing activities, as recent enforcement decisions show a strong desire on the part of the SFC to combat insider dealing. Any liberties taken with proper wall-crossing procedures may be expected to meet with a firm response, under the insider dealing legislation and/or the licensing regime.

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