Insider Dealing: A Primer for Hedge Fund and Private Equity Managers

Whilst the objectives of restricting insider dealing are widely accepted and the conceptual framework is clear, Hong Kong statutory prohibitions on insider dealing can raise practical problems for hedge fund and private equity managers in their day-to-day activities. In this article, we summarize the relevant law and set out examples of common problems.

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Recent Articles

Recent criminal prosecutions for insider dealing in Hong Kong signal a more aggressive approach to an area of law that hedge fund and private equity managers encounter frequently. Although the objective of the law is clear in theory, namely to prohibit profiteering from access to non-public price sensitive information, in practice, the law is surprisingly difficult to apply. For example, when is a hedge fund trader who receives a call from a broker gauging interest in a proposed but not yet announced share transaction restricting from dealing in those shares? When is a private equity firm that conducts due diligence on a potential target company restricted from taking a share position in that company?

Basic Concepts

In Hong Kong, insider dealing is both a civil wrong and a criminal offence. On a criminal indictment, insider dealing is punishable by up to 10 years imprisonment.

Broadly, insider dealing restrictions arise from both fiduciary restraints and statutory prohibitions, the latter set out in the Securities and Futures Ordinance ("**SFO**") and being the more important in Hong Kong. Under the SFO, there are 3 separate categories of prohibitions, one for connected persons, one for takeover bidders and one for tippees. Each category, as it would normally apply to a hedge fund or a private equity manager, is described below.

Connected Person Prohibition

Simplistically, a "connected person" is an insider. Naturally therefore, directors and employees of a listed company are connected persons. However, the term also includes:

- substantial shareholders (*i.e.* persons holding 5 per cent. or more of the nominal value of the share capital of the company);
- professional and business counterparties (*i.e.* persons occupying a position which may reasonably be expected to give them access to inside information of the company by reason of a professional or business relationship); and
- transaction counterparties (*i.e.* persons having access to inside information relating to a transaction, actual or contemplated, involving the company or its securities).

A connected person who has information which he knows is inside information of a company may not deal in securities of that company and may not counsel or procure another person to deal in them knowing or having reasonable cause to believe that the other person will deal in them.

Takeover Bidder Prohibition

Under the SFO, a person who is contemplating or has contemplated making a takeover offer of a listed company and who knows that the information that the offer is contemplated or no longer contemplated is inside information may not deal in securities of the company and may not counsel or procure another person to deal in them otherwise than for the purpose of the takeover. The takeover prohibition, as with the other prohibitions, is co-extensive, meaning, for example, that a person may be subject to both the takeover prohibition and the connected person prohibition at the same time.

Tippee Prohibition

A person who has information about a company which he or she knows is inside information and which he or she received from a person whom he or she knows is a connected person and whom he or she knows or has reasonable cause to believe held the information as a result of being a connected person may not deal in securities of that company and may not counsel or procure another person to deal in them. Equally, a person who receives from a person whom he or she knows or has reasonable cause to believe is a takeover bidder information that a takeover bid is contemplated or is no longer contemplated for a company and who knows that the information is inside information may not deal in securities of that company and may not counsel or procure another person to deal in them.

Inside Information

Broadly, under the SFO, inside information is specific information about a listed company, its securities or its officers which is not generally known to persons who are accustomed or would be likely to deal in such securities but which would, if it were generally known, be likely to materially affect the price of such securities.

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Unsolicited Participations in Transactions

It is not uncommon for a hedge fund manager to receive telephone calls from other financial intermediaries to gauge interest in a transaction relating to shares of a listed company. In this case, the caller may be a connected person, such as where a broker is acting as a placement agent. If so, unless the participants to the call appropriately limit the telephone discussion or the fund manager agrees to accept tippee prohibitions (*i.e.*, to be wall-crossed), the fund manager may unwillingly be prevented from dealing in the shares of the company. This would be so even if the fund manager had plans to do so before the telephone call or had already placed an order in respect of such shares before the telephone call.

Limit Content of Discussions

As alluded to, the first stage prophylactic is to limit the content of the discussion between the caller and the fund manager so that the information relayed never reaches the level where it may be properly regarded as inside information unless the fund manager agrees to be wall-crossed. This means generally that the information must not be specific. As a basic measure, the name of the company may remain undisclosed but this can only be effective where other information does not allow the fund manager to specifically identify the company. What information might specifically identify a company will depend on individual cases.

A problem here for the fund manager is that the content of the telephone call is not under its full control. Indiscretion on the part of the caller or, more simply, differing views between the caller and the fund manager as to whether the content constitutes inside information, could therefore place the fund manager in a difficult position.

Chinese Wall

Where the identity of the company has been inadvertently disclosed without the fund manager's active agreement to cross the wall, the fund manager may still be able to continue to deal in the securities of the company if conditions for statutory exemption are satisfied. One exemption permits dealing where the dealing is done by a person at the fund manager who, as a result of a Chinese Wall, was not tainted by the unsolicited information.

However, the extent to which an *ad hoc* Chinese Wall may be established within the fund manager to contain unsolicited inside information is unclear. This is particularly so where portfolio managers and traders sit in the same area and are privy to telephone discussions of other team members and where there is no existing protocol for immediate and systematic containment.

Private Equity Investments

It is routine for private equity managers to conduct due diligence on companies, including listed companies, before investing in them. At times, the due diligence may be agreed upon by a private equity manager and the controlling shareholder of a target company or the target company itself. In this case, the due diligence afforded will generally be far more extensive than that available from public sources. This due diligence is, of course, good practice but raises a sometimes overlooked issue as to whether or not such due diligence might cause the private equity manager to become subject to a connected person prohibition on insider dealing.

Whether Due Diligence Findings Qualify as Inside Information

A threshold issue is whether or not information acquired in the course of due diligence qualifies as inside information. At first glance, one might assume that it does but this is not necessarily so. Assuming that the listed company has made timely disclosures of all material information as it is required to do under the Stock Exchange of Hong Kong ("**SEHK**") Listing Rules, it is arguable that all information which is likely to materially affect the price of the company's securities is already generally known to persons who are accustomed or would be likely to deal in such securities. Indeed, if it were otherwise, connected persons of the company, such as its directors and officers, would never be in a position to deal in the shares of the company.

Management of Inside Information

Uncertainty arises, however, if the private equity manager's due diligence uncovers material information that was not previously disclosed. If the information is adverse and the private equity manager elects not to proceed with the investment, no issue of insider dealing will arise on the basis that the private equity manager does not deal. This though, assumes that the private equity manager does not have an existing share position which must be unwound. If there is such a position, it is possible that any attempt to close that position on the SEHK before the announcement of the information may constitute insider dealing.

Transaction Structure

On the other hand, if the information is positive, there is a risk that if the private equity manager proceeds with the investment, it will be dealing on inside information. The extent of risk will, in part, depend upon the structure of the investment. Under the SFO, an off-market transaction between 2 counterparties, each of whom is in possession of the same inside information, is exempt from the insider dealing prohibitions. Thus, for example, where the investment will take the form of an off-market acquisition of a minority position and will not require an offer to acquire shares of the company from members of the public, the investment may be exempt on the basis that the selling shareholder and the private equity manager both possess the inside information. Equally, under the SFO, the insider dealing prohibitions only extend to dealing in securities of a listed company. Thus, for example, if the investment were to take place as an asset purchase rather than a share purchase, there would be no dealing in the securities of the listed company and hence, the investment may be exempt from insider dealing prohibitions.

Disclosure or Containment of Inside Information

If however, tax, regulatory or other considerations do not allow for the

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investment to be exempt through an appropriate structure, in some circumstances the solution may lie in appropriate public disclosure of the private equity manager's and fund's connected person statuses. In other circumstances, unfortunately, the solution may require either disclosing the inside information publicly or containing it before it reaches the private equity manager. The former may raise a host of problems, including the likely reluctance of the listed company to publicly announce the information if it gives the perception that it previously failed to properly comply with disclosure requirements under the SEHK Listing Rules. The latter requires the filtering of all due diligence information first through counsel to verify whether or not it has been properly and publicly disclosed, thereby ensuring that the private equity manager does not become tainted with any inside information unless it specifically chooses to be tainted.

Conclusion

Few funds or managers set out deliberately to breach the insider dealing laws. They are more likely to end up on the wrong side of an investigation by mishap than by malice. For this reason, hedge funds and private equity managers should consult with legal counsel to ensure that they have adequate compliance measures in place, specific to their commercial practice, to contain the risks posed by insider dealing. Of equal importance, hedge funds and private equity managers engaged in potential acquisitions or other deals should not overlook the pitfalls that may arise when an acquisition snares inside information on the target company.

TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to asset managers, investment banks, private banks and other financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200. The firm is "highly commended" by the Asia Pacific Legal 500.

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