Obligation to disclose inside information arising from an ongoing M&A negotiation - a recent MMT decision

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While the disclosure of inside information regime under Part XIVA of the Securities and Futures Ordinance (**SFO**) had been in force since 2013, there had not been much judicial guidance as to how the principles under the regime apply in the context of commercial negotiations and incomplete proposals.[1] Many of the previous decisions under the regime concern late disclosure of financial information. Recently, the Market Misconduct Tribunal (**MMT**) handed down its decision (**the Decision**) in respect of Magic Holdings International Limited (**Magic**), which provides useful guidance on this issue. The MMT found Magic and five of its directors culpable for Magic's failure to disclose the inside information arising from L'Oreal S.A.'s (**L'Oreal**) proposed acquisition of Magic in 2013. The Decision addresses issues including the point in time during a negotiation at which inside information arose, attribution of an officer's knowledge of inside information to the company, the application of the safe harbour defence, and the disclosure of relevant information to lawyers. Listed companies and their management should take heed of these issues to avoid a breach of the disclosure requirements.

Disclosure obligations

Management of listed companies are expected to be familiar with the requirements under Part XIVA of the SFO which came into force in 2013. The law requires a listed company to disclose any inside information that relates to the listed company, its shareholders or officers, or its listed securities or their derivatives as soon as practicable, after the inside information has come to (or ought reasonably to have come to) the knowledge of any of its officers. An officer of the listed company will find himself in breach of the disclosure requirement if his intentional, reckless or negligent conduct led to the company's breach. Further, every officer has the duty to take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the company from breaching the disclosure requirement.

There are exceptions to the disclosure requirements, which are commonly referred to as the "safe harbours". One such safe harbour applies where the inside information concerns an incomplete proposal or negotiation. The listed company is allowed to withhold disclosing the inside information if (and only if) it has taken reasonable precautions for preserving the confidentiality of the information, and the confidentiality of the information is in fact preserved.

[1] See our March 2019 client briefing on the part XIVA regime generally and enforcement actions and proceedings taken under the regime.

Salient facts of the case

The case concerned the then proposed acquisition by L'Oreal, in 2013, of the entire issued share capital of Magic, a then Hong Kong listed company in the beauty sector, by way of scheme of arrangement (the proposal was subsequently consummated and Magic was delisted). Discussions and meetings regarding L'Oreal's proposed acquisition were held in as early as March and April 2013 between L'Oreal (including its professional advisers) and the founders of Magic, who held close to 30% of the shares in Magic and were Magic's executive directors.

The Securities and Futures Commission (**SFC**) alleged that inside information arose during those discussions between shareholders and officers of Magic and L'Oreal, which Magic and its officers failed to disclose as soon as reasonably practicable upon the loss of confidentiality of that information. The SFC pursued every member of the then board of Magic (altogether nine officers), each of whom was named a "specified person" in the proceedings before the MMT.

The MMT found that inside information came into existence in a meeting in April 2013, which L'Oreal, its financial adviser, and the three founders of Magic attended. Due to a loss of confidentiality of the inside information, the MMT also ruled that the safe harbour of confidential information concerning an incomplete proposal or negotiation did not apply. Given that Magic only made an announcement in respect the proposed acquisition more than three months after the inside information arose, the MMT found a breach of the Part XIVA disclosure requirements, for which Magic alongside five of its directors (four executive directors and one non-executive director) were held culpable.

When information becomes "specific" in a commercial negotiation

To qualify as inside information for the purpose of Part XIVA, the information should be specific about a listed company, its shareholders or officers, or its listed securities or their derivatives and should not be generally known to the persons who are accustomed or would be likely to deal in the listed securities, but if it were, would be likely to materially affect the share price.

As far as the specificity of the information is concerned, the MMT affirms that in the context of commercial negotiations, '*specific information*' emerges when there is a '*substantial commercial reality*' to the negotiations, which has gone beyond '*testing the waters*'. The MMT ruled that the test was met at the conclusion of the meeting between the founders and L'Oreal on 27 April 2013 (**27 April Meeting**) but not earlier. In arriving at this finding, the MMT focused on the agreement reached between L'Oreal and the founders in the 27 April Meeting, namely: a) an offer price would be '*not less than $5.5 per share*'; b) the founders would support L'Oreal's request to the board for permission to conduct due diligence; and c) the founders would contact the institutional investors of Magic regarding L'Oreal's possible acquisition. It did not matter that the agreement was reached orally in the meeting without any formal documentation. The MMT also took into account the fact that by the 27 April Meeting, L'Oreal had incurred substantial costs in negotiating with the founders by engaging financial and legal advisers and that L'Oreal had communicated to the founders during the 27 April Meeting that it was prepared to '*commit significant external and internal resources*' to complete due diligence. All these showed that the negotiation had gone beyond 'testing the waters'.

> Listed companies are reminded that information regarding ongoing commercial negotiations becomes specific when there is a substantial commercial reality to the negotiation which has gone beyond testing the water. An oral agreement of a price floor and a proposal which is subject to/conditional upon agreement by other parties are no bar to the finding that inside information has arisen.

Attribution of knowledge to the Company: wearing of different hats

Inside information must have come to the knowledge of a listed company to trigger its obligation to disclose. Section 307B of the SFO provides that a listed company would have knowledge if the information has, or ought reasonably to have, come to the knowledge of an officer of the company in the course of performing functions as an officer.[2]

In practice, major shareholders, who may also be directors of the listed company (who were also the founders in the case of Magic), may often be approached by investment banks or potential purchasers about opportunities to acquire a stake in the listed company. It requires case-by-case judgement as to whether the discussions were held by the shareholders as members (in which case knowledge of information would not be attributed to the listed company) or officers of the company (where knowledge would be attributed to the listed company). In the Decision, the MMT rejected the contention that the founders each participated in the 27 April Meeting as officer of Magic. The mere fact that future plans for Magic and the retention of Magic's staff were discussed during that meeting does not suggest that the founders participated as officers of Magic. The MMT accepted that the founders in the 27 April Meeting acted in their personal interests as shareholders.

However, the MMT found that the inside information arising from the 27 April Meeting nevertheless came to Magic's knowledge through its chairman (being one of the founders and executive directors) who contacted institutional investors of Magic after the 27 April Meeting on behalf of Magic, as opposed to in his personal capacity as shareholder. The chairman instructed Magic's employees to arrange the meetings, and used Magic's email address to send out emails to institutional investors, in which he represented that '*the company will have a meeting with your company [the institutional investor]*' (emphasis added).

Therefore, individuals playing multi-roles in respect of a listed company (founder/shareholder/director/senior management) should be clear about the capacity in which he/she is acting and communicate clearly that capacity with parties they are liaising with in a commercial negotiation, such that there can be no misunderstanding as to the capacity in which he/she acted, or inadvertent attribution of knowledge of inside information to the company.

However, listed companies should also note that attribution of knowledge of a shareholder/founder to the company may be inevitable at certain stage of negotiations, when the founder/shareholder is required to act in their official capacity. This would be the case when the matter progresses beyond mere exploratory stage and a wider group of stakeholders is needed to be involved.

Safe harbour and confidentiality

A listed company can avail itself of the safe harbour, if a) it takes reasonable precautions for preserving the confidentiality of the information; and b) the confidentiality is

[2] An officer is defined to include a director, manager or any person in a managing role.

actually preserved. If either of the conditions is not met, the listed company is expected to disclose the inside information as soon as reasonably practicable. This '*safe harbour*' exception is important to businesses which have an interest in maintaining secrecy in commercial negotiations.

(a) finding of loss of confidentiality on the basis of inexplicable price surge

The MMT concluded that the confidentiality of the inside information that came into being in the 27 April Meeting was not preserved because: a) there were 'significant rallies' in Magic's share price from $4.00 on 26 April 2013 to $4.85 on 8 May 2013[3]; and b) '*there was no plausible explanation, other than that the confidentiality of the inside information had not been preserved*'. In relation to the latter, the MMT considered several possible causes of the price surges, including a roadshow in the United States that occurred in early April 2013, the publication of Magic's interim results, and some analysts' reports considering Magic as an acquisition target, before dismissing each of them as unlikely the cause for the price surge from 26 April 2013 onwards. The MMT reasoned that a leak of the confidential inside information is the only game in town that may have caused the price surges.

The MMT also had regard to three separate enquiries made by Magic's supplier, a US fund manager, and another fund on whether L'Oreal was going to acquire Magic when deciding whether confidentiality of the inside information had been preserved. Whilst these enquiries arose prior to the existence of the inside information, the MMT considered that the chairman and the company secretary who were aware of them should have notified the board so that the board could have reached an informed decision as to whether confidentiality in the inside information was lost.

The Decision demonstrates the MMT's willingness to infer a loss of confidentiality on the basis of circumstantial evidence (i.e. unexplained price surges) in the absence of any direct evidence that confidentiality in the inside information had been lost. A listed company should assess the issue of confidentiality by being alert to, and consider any announcement obligation in light of, any inexplicable price surge, rather than take comfort in the lack of direct evidence of a loss of confidentiality.

(b) no reasonable precautions for preserving the confidentiality of the inside information

In deciding whether there were reasonable precautions in place for preserving the confidentiality of the inside information concerned, the MMT examined Magic's systems and procedures and the officers' conduct against the examples of reasonable measures to prevent a breach of disclosure requirement in the *SFC's Guidelines on Disclosure of Inside Information*[4] (**SFC Guidelines**).

While non-disclosure agreements were secured from the founders and institutional investors of Magic at various points during the negotiation with L'Oreal, the MMT found that on balance, Magic had not put in place

[3] Up until mid-April 2013, Magic's share price remained mostly steady at around HK$3.00 with only occasional fluctuations.

[4] SFC Guidelines

reasonable precautions for preserving the confidentiality of the inside information. These failings include:

(i) Magic had '*not established documented controls to identify*' potentially price sensitive information and '*how it should be escalated within Magic*';

(ii) An employee involved in the confidential discussions with L'Oreal throughout (as assistant to one of the founders) had no regulatory training or any prior relevant knowledge or experience; and

(iii) There was no audit trail of meetings and discussions concerning the assessment of the inside information that had emerged, or evidence that '*any considered, particularised assessment had been made*' about its confidentiality. For example, no record was made of the chairman's consideration of whether a particular price surge was a result of a leak of confidential information. Also, there was no record of the information provided to Magic's legal adviser for its advice on disclosure of inside information in relation to the proposed acquisition. Nor was there a record of the legal advice which Magic claimed to have received in the board minutes.

It is clear from the Decision that '*reasonable precaution*' to preserve confidentiality would entail robust controls and systems to ensure that potential inside information is identified and steps are taken in handling the information in a timely fashion (including escalation to the wider board). As such every listed company should have detailed internal guidelines, policies in writing and regular training programmes for officers and employees focusing on the identification and treatment of inside information, in order to provide effective guidance to those who may be exposed to inside information. Further, in order to satisfy the requirement that there be an audit trail, meetings and discussions assessing any inside information and the confidentiality of the same should be documented and such record should be well maintained.

For a listed company who wishes to review the adequacy of its existing processes in relation to disclosure of inside information, measures stipulated in paragraph 60 of the SFC Guidelines are a good starting point.[5] However, do bear in mind that each listed company is expected to consider and implement measures that cater to its specific circumstances.

[5] For example: establish controls, so that any potential inside information is promptly identified and escalated (para 60(a)); maintain and regularly review a sensitivity list identifying factors or developments which are likely to give rise to the emergence of inside information (para 60(c)); authorize one or more officer(s) or an internal committee to be notified of any potential inside information and to escalate any such information to the attention of the board (para 60(d)); document the disclosure policies and procedures of the corporation in writing, etc (para 60(n)).

Disclosure of inside information upon loss of confidentiality

The MMT found that Magic had not made an announcement as soon as reasonably practicable after confidentiality of the inside information was lost in April 2013. The MMT also ruled that Magic had not taken reasonable measures to monitor the confidentiality of the inside information.

> Listed companies should therefore have effective systems in place to monitor the price and trading volume movements of its shares, which identify any unusual movements in share price and trading volume, and therefore point to any possible leak of confidential information. Upon discovering that confidentiality had been lost (especially when there is no valid explanation for the unusual movement in price or trading volume), the inside information should be disclosed as soon as reasonably practicable.

Individual liability in respect of failure to disclosure - same inaction, different rulings

Every officer (which includes independent non-executive directors) is required under the SFO to take all reasonable measures to ensure proper safeguards exist in the listed company to prevent a Part XIVA breach. The MMT found that:

(i) the negligent conduct of the chairman and company secretary, both executive directors, resulted in the breach by Magic of the disclosure requirement, and each of them is accordingly in breach of the disclosure requirement under section 307G(2)(a) of the SFO; and

(ii) the three founders and the company secretary, all of whom were executive directors, and one of the non-executive directors, did not take all reasonable measures to ensure that proper safeguard existed to prevent Magic's breach of the disclosure requirement, and each of them is accordingly in breach of the disclosure requirement under section 307G(2)(b).

In respect of (ii) above, while the SFC argued that all nine Magic directors (four executive directors, two non-executive directors and three independent non-executive directors) failed to take reasonable measures to ensure proper safeguards existed for Magic, only the four executive directors and one of the non-executive directors were found to be in breach. It is of interest that while a non-executive director and two independent non-executive directors admitted that they did not take any active step to ensure there were proper safeguards in place, only the non-executive director was found liable. In finding the two independent non-executive directors not culpable, the MMT took into account the fact that they were both academic research scientists based in the Mainland being appointed to the Magic board for their expertise in cosmetics. It was also clear to the MMT that they did not have any experience in regulatory compliance in Hong Kong. The MMT thus was satisfied that they were entitled to rely on the executive directors to handle the regulatory compliance issues, and by doing so, the MMT viewed that these independent non-executive directors had taken all reasonable measures to ensure proper safeguards exist to prevent a Part XIVA breach by relying on the executive directors.

Regarding the non-executive director that was found liable, the fact that he was a seasoned and senior businessman explained the different expectation the MMT had of him that he should be apprised of the regulatory compliance requirements. Besides, this non-executive director admitted that he abdicated his responsibilities and placed complete

reliance on the executive directors to deal with the compliance issues. The MMT therefore found he '*deliberately took no measures*' and was therefore in breach.

In comparison, the other non-executive director was found to have taken all reasonable measures to ensure that proper safeguard existed, in light of his repeated requests to join the audit committee to understand Magic's controls, as well as his repeated suggestions to appoint an independent consulting firm to conduct an internal control review of Magic, to ensure proper safeguards were in place. Such suggestions were all rejected by the company secretary (also an executive director) on the erroneous ground that Magic's internal control systems were sufficient.

The Decision shows that the assessment of a director's conduct involves the application of an objective standard, having regard to the director's knowledge, skill, experience as well as his/her particular roles and functions on the board (i.e. it involves the question of what would a reasonable director with similar knowledge, skills and roles do).

For independent non-executive directors that are brought on board for their academic or industry expertise and who have no business knowledge, the MMT will have regard to their particular roles and functions on the board and therefore may have different expectation on their degree of involvement in compliance matters of the listed company. That said, independent non-executive directors should not take their duties lightly as the MMT will determine whether a director is liable with regard to the '*specific circumstances*' in each case.

On the other hand, directors who are experienced businessmen and who are more involved in the operation of a listed company should be diligent in discharging their duties under Part XIVA. They should take active roles in ensuring that the internal control systems in place are adequate to prevent a Part XIVA breach.

Directors are also reminded that under the Listing Rules, all directors (regardless of executive or non-executive directors) are responsible for ensuring (i) the listed company's full compliance with the Listing Rules, which include an obligation to announce any inside information which has come to the listed company's knowledge, and (ii) that the listed company establishes and maintains appropriate and effective internal control systems.

Provide all necessary information to the lawyer

The Decision highlights the importance of providing all necessary and relevant information to lawyers when seeking legal advice. This is important as lawyers require all relevant information to give valid and informed legal advice.

Magic's executive directors argued that they used best endeavours to comply with their duties by causing Magic to obtain legal advice as to whether disclosure of inside information was required, and that Magic's legal adviser should be blamed for failing to take instructions on the movement of Magic share price and existence of market rumour for the purpose of giving legal advice. The MMT took the view that that the chairman and/or the company secretary knew about the 27 April Meeting, the enquiries made by third parties as to L'Oreal's proposal to acquire Magic, as well as the unusual movement in Magic's share price and trading volume in April to early May 2013 but did not share such information with

their lawyer. The lawyer was therefore prevented from properly assessing when inside information came into existence and whether announcement of inside information was needed. Noting that '*a party cannot claim protection of his failings by reliance on legal advice which was secured by the failure of that party to provide obviously relevant information to the lawyer*', the MMT found that the chairman and the company secretary could not deny liability by putting the blame on the lawyer. Therefore, listed companies and their officers should provide full information when seeking advice from their lawyers in order that valid legal advice is obtained.

Conclusion

The Decision provides useful guidance in respect of obligation to disclose inside information in the context of an ongoing commercial negotiation. In particular, drawing from the Decision, listed companies should:

(i) be aware that inside information would arise if there is substantial commercial reality to the negotiations which goes beyond mere exploratory testing of the waters and that it matters not that some aspects of the proposed transaction has not been finalised/there are 'hurdles to jump through' before the proposed transaction can proceed;

(ii) actively monitor share prices and trading volumes so that unusual movements are identified and escalated to the board for assessment of whether confidentiality of the inside information had been lost;

(iii) ensure that individuals wearing both hats of a shareholder and officer of the company should be aware of, and make clear to parties they are dealing with, which capacity they are acting in when dealing with them, in order to avoid premature attribution of knowledge of inside information to the company;

(iv) document any consideration and discussion assessing any potential inside information and maintain a written record and an audit trail of the same;

(v) provide full information to the board of directors and/or legal advisers such that any decision made/legal advice obtained is valid and would assist the company in discharging its disclosure obligation; and

(vi) as far as directors are concerned, avoid the mentality that compliance is someone else's problem and placing complete reliance on executive directors and/or company secretary. Instead, every officer is expected to bear the responsibility that proper safeguards exist to ensure compliance with any disclosure obligations. They should be inquisitive of the information provided to them and be proactive in ensuring proper controls exist for the company.

Finally, this case demonstrates that the SFC will go to great lengths in investigations of misconduct and is equipped with the resources to do so. In the investigation against Magic, the SFC interviewed and made enquiries with a vast number of parties involved in the transaction/operation of Magic. The resulting proceedings were long and involved a large number of witnesses and experts. The case only reached a first level decision 7 years after the breach took place and the investigation was started. Therefore, listed companies and their officers should spare no efforts in ensuring compliance with Part XIVA to avoid a breach of the disclosure requirement. Otherwise, they would be embroiled in protracted investigations and proceedings incurring substantial legal costs, let alone the hefty fines and other possible penalties such as disqualification order or 'cold shoulder' order on directors.

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