Guidance Note
A practical guide to good governance

The Hong Kong Institute of Chartered Secretaries
Chartered Secretaries. More than meets the eye.

Insider Dealing
Part 1

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INTRODUCTION

Dealing in shares with the benefit of “insider” information (i.e. price-sensitive and not known to the public investors in security market) was first prohibited in 1974 and was until recently forbidden by the now repealed Securities (Insider Dealing) Ordinance and referred to the Insider Dealing Tribunal for formal inquiry. Since April 2003 insider dealing has been treated as one of the six forms of market misconduct under the Securities and Futures Ordinance (“SFO”).

Under the SFO, market misconduct activity is subject to initial SFC investigation and may thereafter be either referred to the new Market Misconduct Tribunal (“MMT”) or prosecuted in the criminal courts.¹ The first referral to the MMT was instituted in June 2007, while the first criminal prosecution was instituted in January 2008. However, no person can be tried under both proceedings. In other words, there can be “no double jeopardy”. Once either civil or criminal proceedings are under way, they cannot be withdrawn to commence proceedings through the alternative route.

WHAT ARE THE PENALTIES?

Under the civil route, an allegation of insider dealing is “heard and determined” by the MMT, an independent full-time body chaired by a judge or former judge of the High Court who sits with two members of the Hong Kong business and professional community appointed by the Chief Executive. Determinations are made according to the civil standard of proof, i.e. on a preponderance of probabilities.²

The MMT may make civil orders against a person found to have engaged in insider dealing including (i) the payment to the Government of an amount not exceeding the amount of any profit gained or loss avoided; and (ii) his disqualification or discontinuation as a director, liquidator, or

¹ The SFC is empowered to prosecute cases in the Magistrates Court; where such cases are then transferred to the District or High Court, the Secretary for Justice is responsible for future conduct.
² Note that in a ruling delivered on 27 December 2007 the MMT held that the more serious the allegation, the more cogent the required evidence would be.
receiver or manager of a corporation for a period not exceeding five years. However the MMT is not empowered to impose financial penalties or terms of imprisonment.

Since the criminal route will require the higher standard of proof of “beyond reasonable doubt”, it is more likely to be used when the SFC or Department of Justice considers that there is sufficient evidence to obtain a conviction. Penalties under the criminal route are much harsher. Summary convictions in the Magistrates Court carry penalties of imprisonment of up to three years and fines of up to HK$1 million. Convictions on indictment in the District and High Court carry imprisonment of up to ten years and fines of up to HK$10 million.

And the SFO introduces a new statutory right to compensation: investors aggrieved by insider dealing need only point to a MMT determination or criminal conviction in order to pursue their claim and need not sue wrongdoers afresh in the traditional manner.

Given its criminalization in 2003 and the harshness of the maximum penalty, insider dealing is considered a serious offence. Equally, the laws relating to insider dealing are highly technical and complex and it is therefore not the purpose of this guidance note to give legal advice on insider dealing. Comprehensive advice should be sought from specialist legal advisers. The aim of this guidance note is to highlight the main components of insider dealing so as to enhance readers' awareness of this form of market misconduct.

WHAT ARE THE ESSENTIAL ELEMENTS OF INSIDER DEALING?

Under the SFO, insider dealing comprises several essential elements which will be studied in greater detail below. It takes place when a person “connected with” a listed company, having information that he knows is “relevant information” in relation to that company, deals in its or its related listed company's securities or derivatives or counsels or procures another person to do so. Although it is common for individuals to be connected with a listed company by virtue of their ownership or control of private companies, it is important to note that it is dealing in the shares of listed companies to which insider dealing provisions relate.
WHO WILL BE CONSIDERED AS A CONNECTED PERSON?

Under the SFO, the following people are considered as connected with a listed company:-

1. its directors;
2. its employees (regardless of their level or seniority); or
3. its substantial shareholders (meaning one who owns 5% or more nominal value of its voting shares).

While the above groups of people are easily identified as connected persons for the purpose of insider dealing, the following people who may also be covered by the wide definition are more difficult to identify:-

1. a person, who by virtue of a professional or business relationship between himself (or his employer or a corporation of which he is a director or a firm of which he is a partner) and the listed company, may reasonably be expected to give him access to the “relevant information”;

2. a person who is a director, employee or substantial shareholder of another corporation, and by virtue of such position, he has obtained access to “relevant information” in relation to the listed company which relates to a transaction (actual or contemplated) involving both corporations.

It is also noteworthy that any person who contemplates making a take-over offer for the listed company is also deemed under the SFO as an insider if he knows that the information that the offer is contemplated or is no longer contemplated is “relevant information” in relation to the listed company.

As one can see, the definition of connected person covers a wide range of people and particular attention should be given to this area which can be rather tricky.
WHAT CONSTITUTES “RELEVANT INFORMATION”? 

Under the SFO, “relevant information” is defined to mean “specific information about the corporation, a shareholder or officer of the corporation or the listed securities of the corporation or their derivatives, which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but which would if it were generally known to them be likely to materially affect the price of the listed securities”.

“Specific” means the content of the information must be precisely and unequivocally identified, defined and expressed. Mere rumours, vague hopes or worries and unsubstantiated conjecture are not sufficient. In other words, there must be sufficient particulars in the information.

By “not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation”, it means the information is not generally known to the ordinary reasonable investors in the securities of the corporation.

And by “likely to materially affect the price of the listed securities”, it means if the information is known to them, there will be a significant impact on the price of the securities in question.

WHAT ARE CONSIDERED AS “DEALING”? 

“Dealing in” covers the following activities which are carried out by any person either as principal or agent:-

1. sale;
2. purchase;
3. exchange;
4. subscription; or
5. agreement to do any of the above.

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It should be noted that “counseling” and “procuring” another person to deal, knowing or having reasonable cause to believe that the other person will deal in them, is deemed as “dealing” for the purpose of insider dealing, the rationale being that providing insider tips by a connected person (a tipper) to third parties (tippees) is regarded as bad as dealing in the shares under the law.

ARE THERE EXEMPTIONS TO INSIDER DEALING?

The definition of insider dealing under the SFO is so wide that it may catch some activities which are generally considered as ordinary and acceptable. Certain activities are therefore expressly excluded from the scope of insider dealing.

Under the SFO, dealing in (as well as counseling and procuring another person to deal in) listed securities or derivatives for the sole purpose of qualifying as a director of a corporation, in the performance of an underwriting agreement or in the performance in good faith of his functions as a liquidator, receiver or trustee in bankruptcy, will not be regarded as insider dealing. In each of these situations, the purchase or sale (as the case may be) is carried out pursuant to a formal obligation and not motivated primarily by any inside information.

~ To be continued ~

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