

Due Diligence in Share Acquisitions: Navigating the Insider Trading Regime

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Due Diligence

- An important risk mitigation tool
- Investigation into the affairs of the target
- Outcomes of due diligence
 - Deal-breaker
 - Value-reducer
 - Transaction Structuring
 - Deal Protection Devices

Due Diligence

- Availability of information
- Due diligence more relevant in unlisted companies
- Public listed companies
 - Disclosure requirements under securities regulation
 - Publicly available information
 - Relevance of due diligence
 - Limiting acquirers to market information not always possible

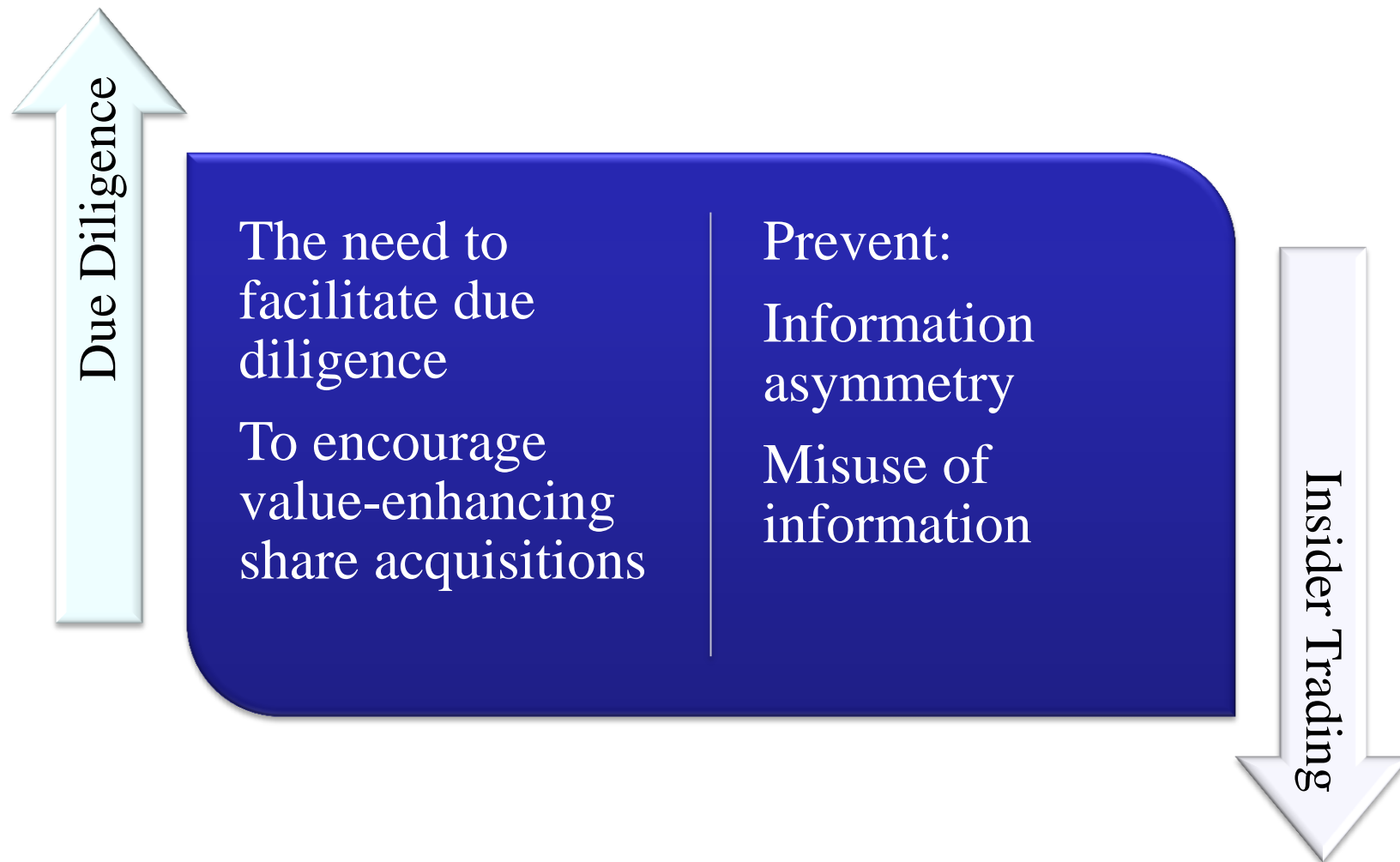
Inside Information

- Elaborate due diligence in listed companies and the risk of insider trading violations
- Acquirer enjoys preferential treatment
 - As against other shareholders of the target
- Causing information asymmetry

Inside Information

- Information that is not within the public domain (unpublished)
- Material in nature
- Price-sensitive, e.g.
 - Significant announcement such as financial results, dividend declaration
 - Mergers & acquisitions transactions
 - Issuance or buyback of shares
- Unpublished price-sensitive information (UPSI)

The Problem

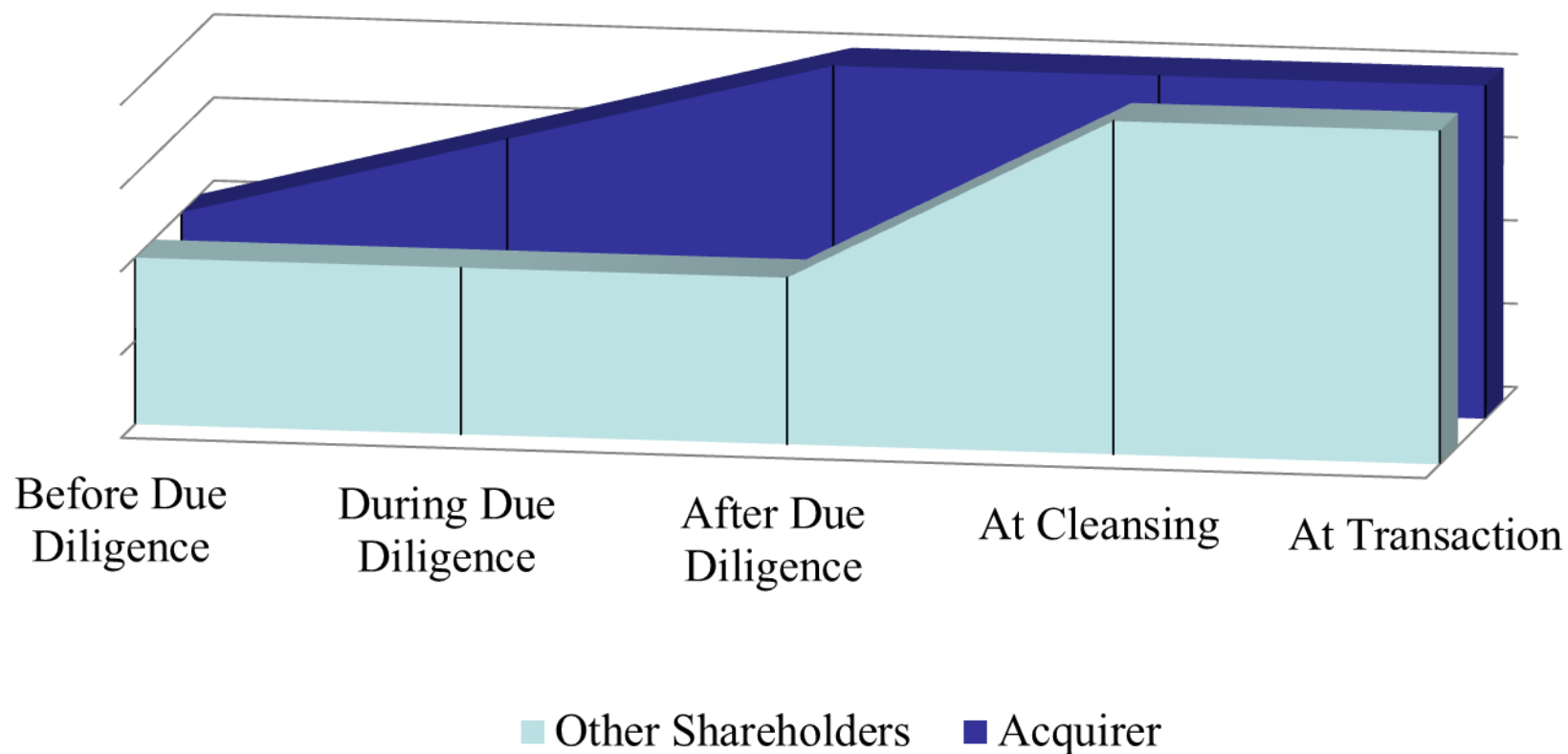


The Core Argument

- Theoretical perspective
 - Reconciling the objectives of the acquirers with the goals of insider trading law
- Temporary asymmetry in information
 - Acquirer may obtain superior information through due diligence
- Restoration of parity of information
 - Public announcement of inside information prior to the transaction
 - “Cleansing” mechanism

The Core Argument

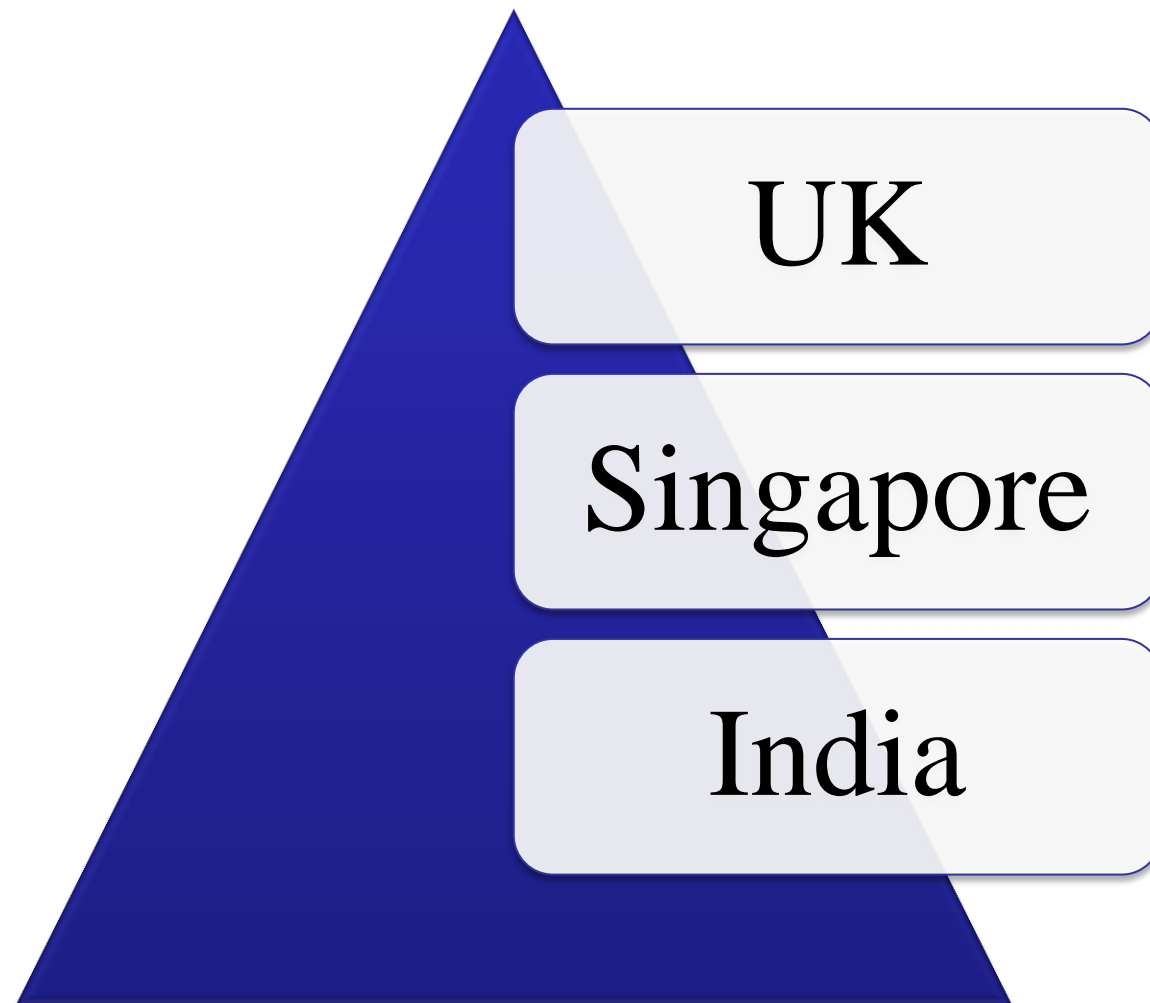
Chart Title



Conditions

- Acquirer:
 - To maintain confidentiality
 - Not to trade in target's stock
- “Win-win” situation
 - Allows acquirer to conduct due diligence
 - But not to the detriment of target's shareholders

Examples from 3 Jurisdictions



Regulatory Framework

UK

- Criminal Justice Act 1993
- FSMA 2000
- Code of Market Conduct
- EU Reforms
- Takeover Code

Singapore

- Securities and Futures Act
- Takeover Code

India

- SEBI Act
- SEBI Regulations on Insider Trading
 - 1992
 - 2015

“Parity of Information” Approach

Communication Offence

- Liability for disclosure of information
- Except in certain specified circumstances
- Usually falls on management of the target

Trading Offence

- A.k.a “dealing” offence
- Insider trades while in possession of inside information
- Usually falls on acquirer

“Parity of Information” Approach

... the focus is on the information the person trading has, not how he or she obtained it from his or her source, or whether or not he or she intended to violate the law

Greene & Schmid (2013)

“Parity of Information” Approach

- Strict liability
- Blameworthy state of mind not required
- Substantially expands the scope of insider trading regulation
- Contrast with US approach
 - Follows the fiduciary theory
 - Breach of duty owed to the company, shareholders or the source of information

“Parity of Information” Approach

- Trading “on the basis of” inside information
 - Use vs. possession
- EU: *Spector Photo Group NV* (ECJ, 2010)
 - Mere possession of inside information while trading triggers a presumption of “use”
 - Rebuttable presumption – onus on trading party
 - Mental element could weaken preventive mechanism for insider trading

“Parity of Information” Approach

- India: Decisions of the SAT
 - Similar approach followed
- Genesis in *Rajiv Gandhi* (2008)
 - Followed in several other cases, including *Chandrakala* (2012) and *Manoj Gaur* (2012)
- Initial presumption is that insider has traded “on the basis of” UPSI
- Can be rebutted by insider who carries burden of proof to the contrary

“Parity of Information” Approach

- Insider must establish a different motive
- E.g.
 - Routine trading of securities
 - In target and other companies
 - Both buy and sell orders
 - Successful argument in *Manoj Gaur*
 - Other reasons such as personal emergencies
 - Planned sales (e.g. ESOP shares)

“Parity of Information” Approach

- In sum, the theory places significant barriers on due diligence
- Intention and motive are irrelevant
- A strict approach would render due diligence impossible
- Hence, “limited parity of information” approach
 - Selective disclosure justified so long as certain conditions are satisfied
 - E.g. “mosaic theory”

Share acquisitions through takeover offers

- Usually to obtain control

Share acquisitions without takeover offers

- Usually to take a minority stake

TAKEOVER OFFERS

Takeover Offers

- Due diligence with a view to a takeover offer
- Such offers require significant disclosure of information to shareholders
- Equal treatment principle
- Rationale for due diligence operates the strongest

Takeover Offers

- “Parity of information” rule
 - Information to be provided equally and simultaneously to all shareholders
- UK & Singapore
 - Recognises provision of information to acquirer
 - Equality of information
 - All bidders must have equal access
 - No selective disclosures

Takeover Offers

- Due diligence
- Discussions with prospective sellers about irrevocable undertakings
- Discussions with banks and financial institutions about acquisition financing
- UK & Singapore provide for safe harbour provisions in a takeover offer
- India – provides safe harbour for “communication” but not “trading” offence

Takeover Offers

- Pre-trading Disclosures
 - Either cleansing announcement or information in takeover offer document
 - Price-sensitive information only
 - Not other technical and routine information
- Lack of clarity about what is to be disclosed
 - Takeover regulations do not specify inside information

Takeover Offers

- Lack of clarity in all jurisdictions as to disclosure to be made
- EU reforms address the issue
 - At the time of acceptance of the offer “any inside information” to be made public

Takeover Offers & Stakebuilding

- Acquisition of shares before launching offer
 - “Toe hold”
 - “You do not attack a citadel before having established your camp sufficiently close to the walls”
- Acquirer prevented from dealing with inside information
- Activity falls within general prohibition
- Hence, stakebuilding must precede due diligence

Takeover Offers & Stakebuilding

- Acquirer's intention to make an offer
 - Whether inside information?
- UK and Singapore provide for specific safe harbours
 - Excludes knowledge of previous transactions or of intended transactions from inside information
- India does not carry a specific safe harbour
 - Need for clarification

ACQUISITIONS WITHOUT TAKEOVER OFFERS

Acquisitions Without Takeover Offers

Transaction Types

Secondary Market

Primary
Market

Stock exchange
Block trade

Negotiated off-
market trade

Private
placement
(PIPE)

Due Diligence in PIPEs

- Different from takeover offers
 - Generally, no significant disclosures to shareholders
 - No offer to shareholders
 - Lack of exit mechanism
 - Only decision-making by shareholders through vote
- Limited justification for due diligence
- Greater need for cleansing to maintain “parity of information”

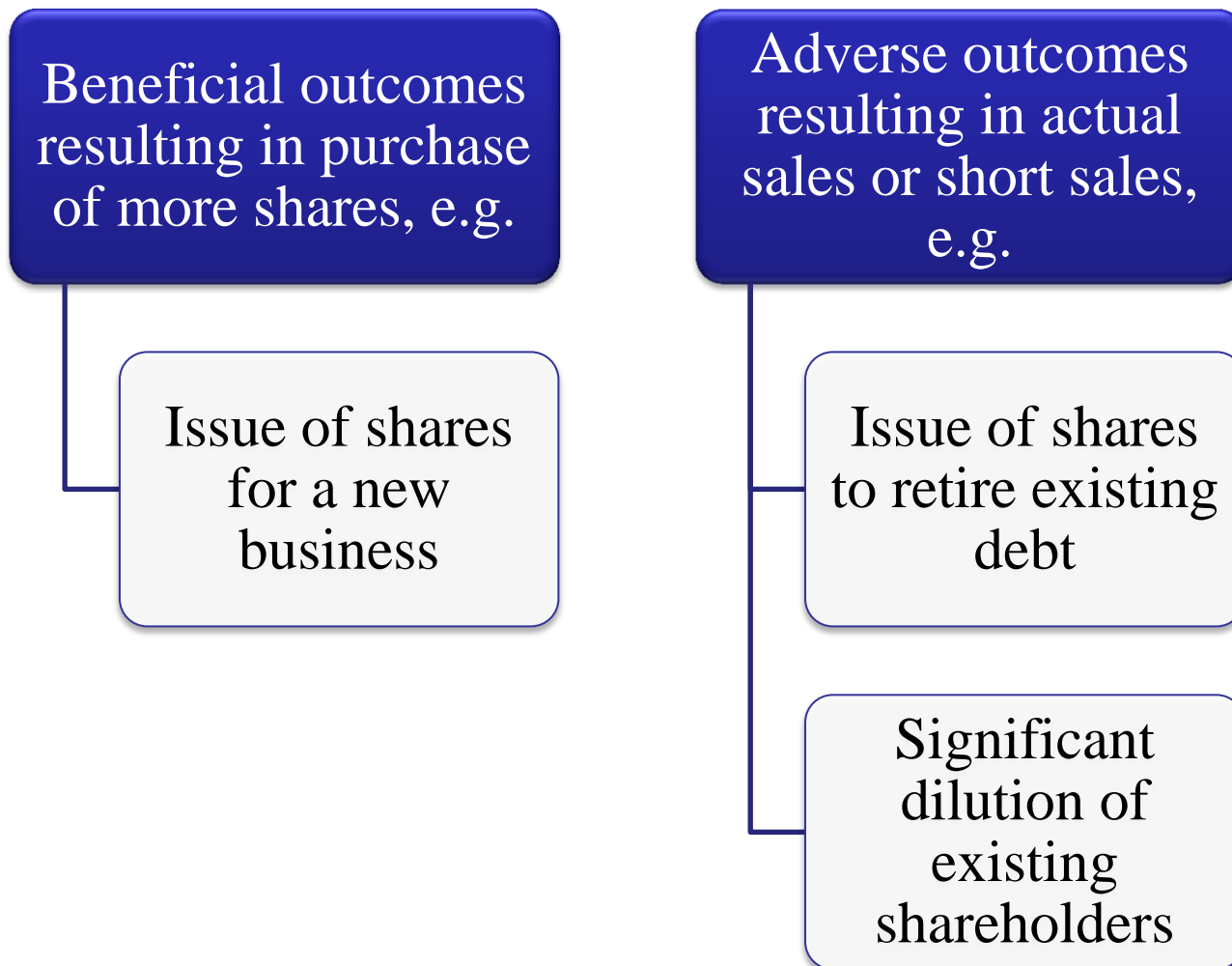
Due Diligence in PIPEs

- In PIPEs, all three jurisdictions require cleansing before executing the transaction
 - This would avoid the “trading” offence
- In UK and India, express safe harbour for “communication” offence
 - Less clarity in Singapore

Market Sounding

- Enquiry by target company with certain investors to ascertain interest in PIPE deal
- That itself may constitute inside information
- Influence on the price of the shares

Market Sounding

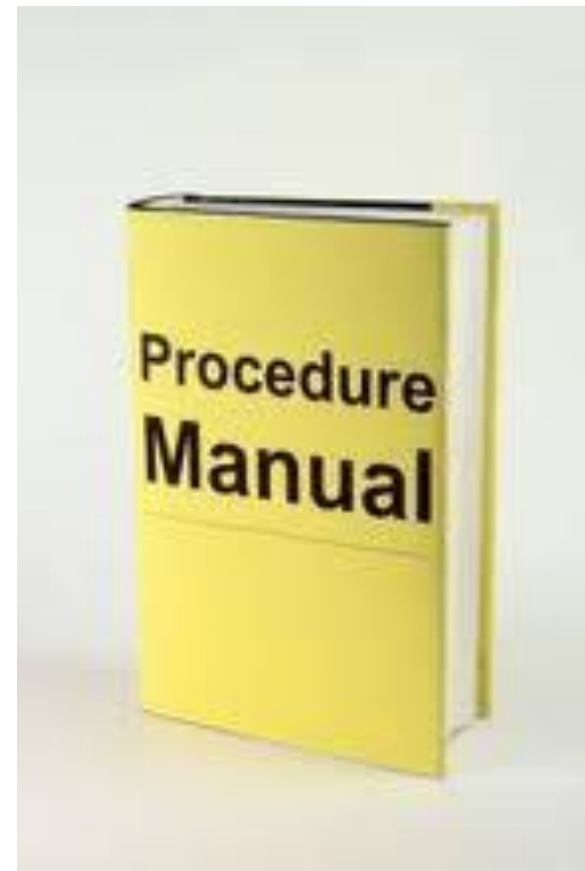


Market Sounding

- Detailed framework devised in the UK
- Permissible disclosures
- Confidentiality requirements
 - “Wall-crossing”
- Active enforcement by the FCA/FSA

Market Sounding

- Strict regime in UK
- Lack of clarity in Singapore and India
- Empirical evidence on market sounding and wall-crossing
- Need for detailed procedures – targets and investors



CONDITIONS FOR DUE DILIGENCE

Conditions

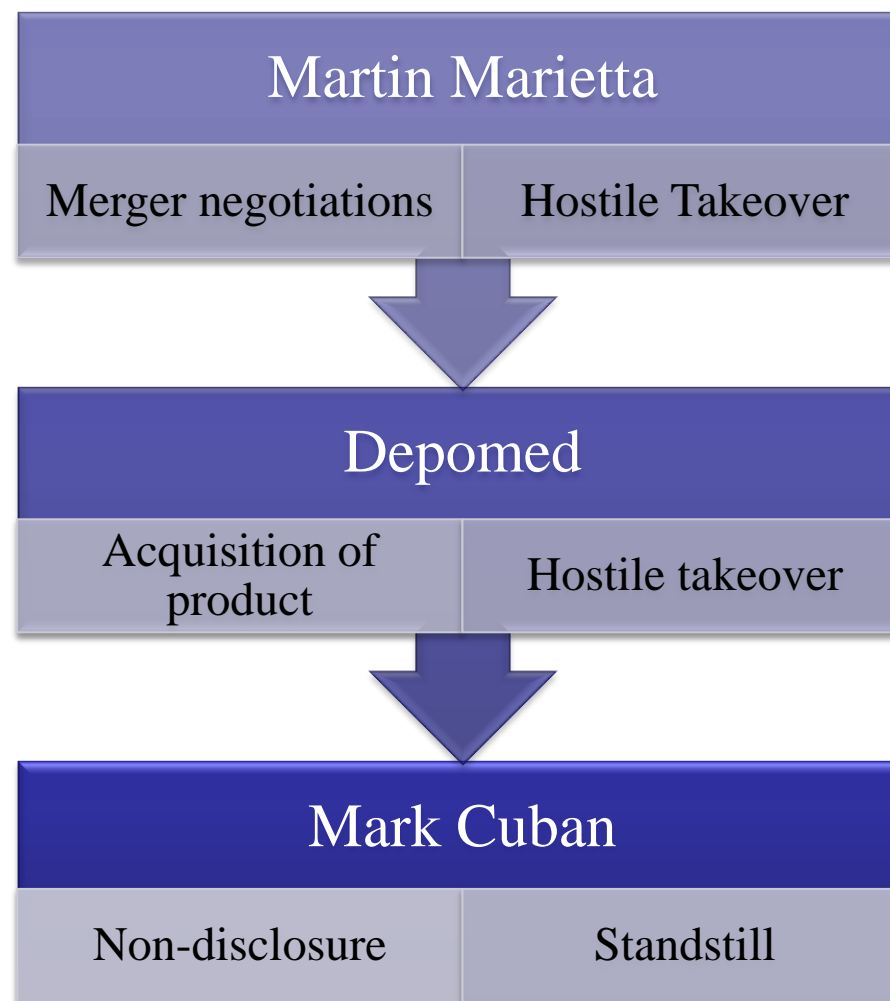
Confidentiality Obligations

Other Conditions

- Profession, employment, duties
- Interest of the company

Confidentiality

- Verbal or written
- Non-disclosure
- Non-use
- Standstill obligations



Other Conditions

- UK
 - Disclosures in furtherance of employment, profession or duties
 - Legitimacy condition
- Narrow interpretation
 - *Gronggaard & Bang* (ECJ, 2005)
 - Need for close link between disclosure and exception
- Interests of the company
 - Condition under common law
 - Codified lately
 - Specific provision in India
- To be determined by the board

DEAL FAILURE

Treatment of Inside Information

- Lack of clarity in all jurisdictions
- Regulators and practitioners to devise methods of dealing with the issue
- No “trading” offence, but “communication” may have occurred
- Possibility of cleansing announcement
 - Before acquirer can deal in the target’s shares

Treatment of Inside Information

- Information regarding the deal itself
- If possibility of deal is announced
 - Then, status of deal to be disclosed publicly
- If deal not yet announced
 - Then, the need for cleansing announcement depends on the circumstances
 - Clarification provided by FSA in the UK

Conclusion

- Importance of due diligence in an acquisition transaction
- Need for balance with insider trading regulations
- Due diligence with cleansing requirement
- Need for updating legal framework to fit within the paradigm

THANK YOU

Questions?

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