Insider Trading – What Directors of Public Listed Companies Need to Know (Part 1)

Insider trading has received increased regulatory scrutiny in the Malaysian market over the past decade, posing several important questions for those who are privy to confidential information.

Some of the most common issues facing directors of public listed companies ("**PLC**") is determining:

(i) What are the specific rules that govern their share trading?

(ii) When can directors buy or sell the shares of companies on whose boards they sit?

(iii) Can a director be in breach of insider trading laws even if they individually do not trade but instead share confidential information with others?

(iv) Are directors the only ones at risk of being in breach of insider trading prohibitions?

These are issues that often face those who deal with inside information, particularly directors and company advisers such as lawyers and investment bankers. Thus, what can directors and other corporate insiders do to ensure that they stay on the right side of the law?

What is Insider Trading

So, what exactly is insider trading? Essentially insider trading means to buy or sell securities while a person is in possession of material non-public information. The key question therefore is what makes a person an "insider'' under the law.

The law prohibiting insider trading in Malaysia is set out in the Capital Markets and Services Act 2007 ("**CMSA**") which regulates the activities, markets and intermediaries in the capital market. Sections 183-198 set out the specific parameters of what is regarded as insider trading and the applicable defences under the law. This framework which was designed to achieve fairness and confidence in the securities market was described in the following terms by Justice Azizul Azmi Adnan in the recent case of *Suruhanjaya Sekuriti Malaysia v. Sreesanthan Eliathamby [2021] 7 CLJ 913* :

"The underlying principle was that insider trading undermines the belief in the fairness of, and the confidence in, the securities market. The long term viability of a securities market is thought to depend on the confidence that participants have in its integrity and their ability to participate in it on level terms''.

The first point to note is that regardless of whether a person holds a position in a company, such as a director or employee or whether a person is an outsider to the company, the law applies in a similar fashion - the crucial premise being whether a person is in possession of inside information and knows that the information is not generally available. This shift in approach took place when the insider trading laws were revamped in 1998. Prior to that year, the prohibition against insider trading operated against a person who owed a duty of loyalty to the company and he was therefore prohibited from misuse of confidential price sensitive information.

The position now is set out in section 188(1) of the CMSA which states that:

"a person is an insider if that person:

(a) Possesses information that is not generally available which on becoming generally available a reasonable person would expect it to have a material effect on the price or the value of securities; and

(b) Knows or ought reasonably to know that the information is not generally available."

The cases decided by the Malaysian courts demonstrate this principle. In the case of *Suruhanjaya Sekuriti Malaysia v. Chan Soon Huat* [2018] 9 MLJ 782, a former director of a construction company was held to be in breach of the insider trading prohibitions based on the civil standard of proof, with circumstantial evidence being accepted by the court that the defendant had inside information at the time of the trades. The information in that case related to the cancellation of a contract worth RM4.6 billion for the construction of racecourse in Dubai, where a Malaysian public listed company was involved in a joint venture.

In the case of *Suruhanjaya Sekuriti v. Sreesanthan Eliathamby [2021]7 CLJ 913, (* currently on appeal to the Federal Court), a corporate lawyer who at the material time was involved in advising on the legal aspects of a proposed privatisation, was held to be an insider for purposes of the insider trading prohibition in s.89E(1) of the Securities Industry Act 1983 (now contained in section 188(1) of the Capital Markets and Services Act 2007). The High Court decided that while insider trading is not a strict liability offence, what is necessary to establish "mens rea" (intent or mental state) under the law is to prove that an accused or defendant knew or ought reasonably to know that the information in his possession was not generally available.

Why then does this prohibition present so many difficulties? Oftentimes, the challenge revolves around determining when information is considered material.

Determining Materiality

It helps to start with a simple illustration. Let's say a company decides to dispose a fleet of its old cars which were used by its directors and CEO. The board having discussed this proposal is aware of the fact. One of the company directors sells some of his shares in the company after the board meeting where this was discussed. Is this insider trading?

In this case, it is highly unlikely to constitute insider trading because the information that the director has is not material. In determining whether information is material, the law sets out an objective test in section 185 of the CMSA, which is *"whether such information would or would tend to, on becoming generally available, influence reasonable persons who invest in securities in deciding whether or not to acquire or dispose such securities"*.

Who then can be regarded as a 'reasonable investor'? In the case of *Chua Seng Huat v PP [1993] 3 MLJ 327*, the court was of the view that daily retailers who are out to make a quick profit would not qualify as a 'reasonable investor'. Rather, he is "*an investor who possesses general professional knowledge"* which includes among others, the ability to analyse and determine the quality and the prospect of shares, which goes towards deciding when to buy. It requires the ability to do technical and fundamental analysis on information that is freely available, fundamental analysis being the intrinsic valuation of a stock which involves studying of financial strength ratio, operating ratio and profitability ratio and the use of variation measures like price-earnings ratio, dividend yield and the price-to-book ratio. He is one who also has the knowledge that technical analysis is concerned with – i.e., examining the price and the volume behaviour of a share, and the knowledge of how to read and analyse financial accounts and statements.

This case would suggest therefore that a sound understanding of the fundamentals of investing and the ability to analyse financial statements is a pre-requisite to being regarded as a reasonable investor.

Coming back to the disposal of the fleet of old cars and applying it to the test described above, one can easily conclude that a reasonable person who invests in securities clearly would not be influenced in his trading decisions by this paltry piece of news.

What if, however, the information relates to a loss forecast involving the company's quarterly financial results. Would this information influence a reasonable investor in deciding whether or not to sell the company's shares? Decided cases indicate that the answer to this is a yes. In the Singapore case of *Lew Chee Fai, Kevin v. Monetary Authority of Singapore [2012] 2 SLR 913*, the court decided that a loss forecast in a company's quarterly financial results was material information. The court approached the question in this way, referring to the US case of *TSC Industries Inc. v. Northway Inc 426 US 438 (1976)*, *"the information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote … It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."*

What if the information about the loss forecast was already circulating in the financial news? Would this make any difference? In the case of *Lew Chee Fai*, the court took the position that the information on the company that was generally available at the time of the appellant's alleged insider trading transaction was too weak for the common investor to draw the deductions, conclusions and inferences that would enable him or her to arrive at the same content as that contained in the information possessed by the appellant. Based on this reasoning, the quality of information that the insider has would bear heavily on the decision of a court on this point.

In the recent *Sreesanthan* case*,* the court held that information relating to a proposed privatisation was material for several reasons. Among them, was that there was a sharp increase in the share price of the company following a publication of an article in a newspaper and the announcement on the stock exchange several days later relating to the company's proposed privatisation. Additionally, the learned judge concluded that a reasonable investor would contemplate that in a privatisation, the shareholder who undertakes the exercise must offer a price that is attractive enough for other shareholders in the company to vote in favour of the privatisation, regardless of the mode by which the privatisation was to be effected. A crucial point was underscored by the judge in this case – the fact that the privatisation was contemplated was information that a reasonable person would expect to have a material effect on the price of the shares concerned. It was not necessary for the SC to prove that the defendant knew, at the time he traded in the shares, which route the privatisation was to take or what the offer price of the shares was to be.

A frequently raised issue is whether information which is not final or concrete can still fall within the prohibitions in the law. In the Malaysian case of *PP v. Chua Seng Huat [1999] 3 MLJ 305*, this argument was raised by the accused, the managing director of a PLC who was given certain financial information in the form of management accounts relating to subsidiaries and associates of the listed company. The information indicated that the financial performance of the companies was declining. One of the defences raised by the accused was that the monthly management accounts may not have been completely accurate at the time the insider activity took place, as certain information such as the closing stock figures were not available at the time. The court rejected this argument and held, that despite certain inaccuracies in the information itself, it was not entirely unusable and could therefore be regarded as "specific information" for purposes of the law. Although Chua's case was decided under sections 89 and 90 of the Securities Industry Act 1983, i.e. prior to the far reaching amendments of 1998, this principle however can be found in the current provisions of CMSA where the term "information' is defined broadly in section 183 to include 'matters of supposition or other matters that are insufficiently definite to warrant being made known to the public'.

Trading when information is not generally available

Insider trading occurs when there is trading of securities by a person in possession of non-public material information. What then should a director do if he or she wants to trade but the company is unwilling to prematurely disclose material information because negotiations on a potential transaction are still ongoing? This is often the conundrum, the classic dilemma that directors or other company insiders find themselves in when a major acquisition is in the pipeline. Mergers and takeovers are a common example. Announcing one's plans for an acquisition before details are properly firmed up can spell disaster for a corporate exercise. It is a known fact that arranging the necessary financing, deciding on the offer price, addressing how resources such as existing staff and management will be managed and ensuring that there is buy in from major shareholders of the target company, all take time. Announcing a takeover too early in the day may scuttle these well laid out plans, leaving the potential acquirer with a thwarted and yet costly endeavour.

In fact, even Bursa Malaysia's Listing Requirements make it clear that there are situations in which a listed company may be able to withhold disclosures if this is necessary. According to rule 9.05(3) of Bursa Malaysia's Main Market Listing Requirements (MMLR), in exceptional circumstances, a listed issuer may temporarily refrain from disclosing material information. These are where:

(a) immediate disclosure would prejudice the ability of the listed issuer to pursue its corporate objectives;

(b) when the facts are in a state of flux and a more appropriate moment for disclosure is imminent; or

(c) where the laws prohibit the disclosure of such information.

These however are fairly limited circumstances and listed issuers are reminded that these constitute an infrequent exception to the normal requirement of immediate public disclosure and that in cases of doubt, the presumption must always be in favour of disclosure (see MMLR rule 9.05 (2). In such a situation, the directors may wish to consider the approach aptly termed by the US authorities as 'disclose or abstain' which, in a nutshell, means that if one cannot disclose the information, then they would need to abstain from carrying out the trades.

In the next part, we will delve into considerations that directors need to take into account in the event they do not trade but procure another person, whether directly or indirectly, to buy or sell securities when the director is in possession of inside information, closed periods as defined by Bursa Malaysia, and actions that can be taken by Malaysian regulatory authorities in the event of a breach of insider trading prohibitions.