NUS Working Paper 2016/004
NUS Centre for Law & Business Working Paper 16/01

Due Diligence in Share Acquisitions: Navigating The Insider Trading Regime

Umakanth VAROTTIL

v.umakanth@nus.edu.sg

[April 2016]

Centre for Law & Business
Faculty of Law

NUS Working Paper 2016/004
NUS Centre for Law & Business Working Paper 16/01

Due Diligence in Share Acquisitions: Navigating The Insider Trading Regime

Umakanth Varottil (v.umakanth@nus.edu.sg)

[April 2016]

DUE DILIGENCE IN SHARE ACQUISITIONS: NAVIGATING THE INSIDER TRADING REGIME

Umakanth Varottil[*]

Abstract

The goal of this paper is to unpack the underlying friction between the need to facilitate due diligence in share acquisition transactions that could place inside information in the acquirer's hands, and at the same time to ensure that such information is not misused by the acquirer to the detriment of the other shareholders, a matter that insider trading regime regards as sacrosanct. In analysing and seeking to resolve this tension, this paper draws upon examples from three jurisdictions, namely the United Kingdom (UK), Singapore and India. The core argument of this paper is that from a theoretical perspective the due diligence objective of acquirers can be reconciled with the goals of the insider trading regime in order to preserve the interests of the target shareholder as long as certain restrictions are placed on the conduct of the acquirer.

Key words: Due diligence, insider trading, parity of information, takeover, market-sounding, wall-crossing

[*] Associate Professor, Faculty of Law, National University of Singapore. The author wishes to thank (i) Chen Weitseng, Michelle Dy, Florian Gamper, Alan Koh, Sandeep Parekh, Maziar Peihani, Aparna Ravi, Justin Tan, Hans Tjio and Wan Wai Yee for discussions and comments on a previous version of this paper, (ii) Radhika Indapurkar and Soumya Shekhar for research assistance, and (iii) the National Institute of Public Finance and Policy, New Delhi, the Centre for Law & Business at the National University of Singapore and the Commercial Law Centre at the University of Oxford for various forms of support during the research and writing of this paper. The usual caveat applies.

The final version of this paper is to be published in the Journal of Business Law (forthcoming, 2017).

I. Introduction

Due diligence is a quintessential step in a share acquisition transaction, whether an acquirer seeks to obtain a controlling stake in a company, being the target, or a significant minority stake in it.[1] It is the process by which the acquirer conducts a detailed inquiry into the affairs of the target before it decides whether to proceed with the acquisition. Since the acquisition will require the acquirer to assume a financial risk, it would be prudent on its part to obtain sufficient information on the conduct and affairs of the target, and to mitigate those risks to the extent possible.[2] Even when the acquirer does decide to proceed with the transaction, the due diligence will enable it to assess the true value of the target so as to determine the acquisition price, to structure the transaction through the optimal route and also to incorporate suitable protective mechanisms in the deal documentation.[3]

If the target happens to be a listed company, the justification for due diligence becomes less compelling or, at least, its scope limited. As such a target is subject to strict disclosure norms imposed by securities regulation that require it to keep the market informed of all material developments, the acquirer could make the acquisition decision based simply on publicly available information. Hence, in theory, unless there are compelling reasons for the target's non-disclosure of material information (such as ongoing negotiations for a significant commercial contract or preparation of draft financial statements) to the public, an acquirer would not be able to unearth inside information during due diligence. However, such an idealistic assessment tends to break down in practice as acquirers making significant investments are entitled to seek information from the target that may very well be in excess of what is in the public domain.[4] Forcing acquirers to rely only on market information to make significant acquisitions will have a chilling effect on the market for share acquisitions that may otherwise be in the interest of the target and its shareholders.

At the same time, due diligence in listed company acquisitions encounters certain regulatory barriers in the form of the insider trading regime.[5] At the outset, given that information regarding share acquisition transactions such as takeovers is generally price

---

[1] Where appropriate, the target is referred to in this paper as the "issuer", and the acquirer as "offeror" or "investor".

[2] Vanessa Williams, *Due Diligence: A Practical Guide*, 2nd ed. (Bristol: Jordan Publishing, 2013) at 5.

[3] Wan Wai Yee & Umakanth Varottil, *Mergers and Acquisitions in Singapore: Law and Practice* (Singapore: LexisNexis, 2013) at [4.10].

[4] Denzil Rankine, Graham Stedman & Mark Bomer, *Due Diligence: Definitive Steps to Successful Business Combinations* (Harlow: Pearson Education Limited, 2003) at 176.

[5] In some jurisdictions, insider trading is referred to as "insider dealing".

sensitive in nature, such information must be maintained in utmost confidence, as the risk of insider trading is high.[6] Consequently, an elaborate form of due diligence exercise will exacerbate the risk of falling afoul of insider trading regulation. Moreover, due diligence in a listed company scenario perpetuates information asymmetry that militates against the goal of the insider trading regime, as it undermines market integrity. By giving an acquirer inside information during due diligence that is unavailable to other investors, the acquirer enjoys preferential treatment that may be against the interests of the other (mostly minority) shareholders of the target.[7] It is this disparity that gives rise to more fundamental questions that strike at the heart of the intersection between the need for due diligence to promote share acquisition transactions that may be value-enhancing in nature for the company as a whole (including its shareholders), and the information asymmetry created by the process that makes the very same shareholders vulnerable to the actions of the acquirer with superior information regarding the target.

The goal of this paper is to examine the underlying friction between the need to facilitate due diligence in share acquisition transactions that will place inside information in the acquirer's hands, and at the same time to ensure that such information is not misused by the acquirer to the detriment of the other shareholders, a matter that insider trading regime regards as sacrosanct. In analysing and seeking to resolve this tension, this paper draws upon examples from three jurisdictions, namely the United Kingdom (UK), Singapore and India.

The core argument of this paper is that from a theoretical perspective the due diligence objective of acquirers can be reconciled with the goals of the insider trading regime in order to preserve the interests of the target shareholders as long as certain restrictions are placed on the conduct of the acquirer. Due diligence temporarily causes information asymmetry whereby the acquirer becomes privy to inside information[8] that is unavailable to the other shareholders, but parity can be restored if the acquirer (or the target) is required to publicly disclose any such inside information to the market before the acquirer proceeds with the transaction (a phenomenon referred to as "cleansing"). This must be accompanied with the condition that the acquirer cannot trade in the target's

---

[6] Brian McDonnell, *A Practitioner's Guide to Inside Information*, 2nd ed. (London: Sweet & Maxwell, 2012) at 248; Henk Berkman, Michael D. McKenzie & Patrick Verwijmeren, "Hole in the Wall: Informed Short Selling Ahead of Private Placements" (16 October 2013), available at http://ssrn.com/abstract=2233757, at 1.

[7] Hans Tjio, *The Principles and Practice of Securities Regulation in Singapore*, 2nd ed. (Singapore: LexisNexis, 2011) at [8.02].

[8] The expression "inside information" has specific connotations under the legal regime and generally relates to non-public information of a precise nature, which, if available generally, would have a material effect on the price of the securities of a company. See, Financial Services and Markets Act 2000, s. 118C(2) (UK); *Madhavan Peter v Public Prosecutor*, [2012] 4 SLR 613 at [142] (Singapore); SEBI (Prohibition of Insider Trading) Regulations 2015, reg. 2(n) (India, where the expression "unpublished price sensitive information" is used).

shares while it is in possession of inside information, nor can it disclose that information to any other person. The only advantage the acquirer gains is that it is able to examine the affairs of the target and then decide whether it wishes to proceed with the transaction or not. If it does decide to proceed, it must give up any informational advantage through a cleansing announcement. This can be considered a "win-win" situation whereby the acquirer is motivated through the due diligence exercise to embark on a transaction that may be beneficial to the target and its shareholders, but at the same time it must relinquish its informational advantage before it actually acquires the shares so that a similar level of information is available to all shareholders at that stage.

This paper finds that while the UK, Singapore and India have adopted the aforesaid broad policy framework within their respective insider trading regimes, there is not only disparity in the level of detail in the regulation to achieve this framework, but in many cases they do not fully address the entire range of protections required for the framework to function effectively.

Part II of this paper begins with an introduction to the regulatory framework in the UK, Singapore and India and discusses the policy imperative of "parity of information" that underpins the insider trading regime in these countries. The interplay between due diligence and insider trading operates through a bifurcated approach depending upon whether or not the share acquisition results in a takeover offer for the target. Hence, Part III explores the issues arising out due diligence resulting in takeover offers, and Part IV examines those arising from transactions that do not involve takeover offers. Part V discusses some of the conditions on which due diligence may be allowed in listed companies. These include the need for a confidentiality obligation on the part of the acquirer and certain duties on the part of the target and its directors and officers. Part VI explores a scenario where the transaction does not proceed after due diligence and the acquirer continues to be in possession of inside information. Part VII concludes with a broad analysis of the lessons from these scenarios in the three jurisdictions.

II. Insider Trading in Share Acquisitions: Policy and Regulation

This part examines the policy imperative surrounding insider trading that impairs an unrestricted due diligence process in public listed companies. Before doing so, it briefly sets out the broad framework for regulating insider trading in the UK, Singapore and India.[9]

[9] A detailed analysis of the evolution and implementation of insider trading regulations in these jurisdictions is beyond the scope of this paper.

A. Regulatory Framework for Insider Trading

Among the three jurisdictions, the UK has the most elaborate regulatory framework, which is also in a state of transition. It adopts a multipronged approach towards insider trading through criminal and civil legislation. The criminal offence of insider dealing is addressed in the Criminal Justice Act 1993. However, the civil response, which forms the basis of this paper, is contained in the Financial Services and Markets Act 2000 ("FSMA"). The FSMA was substantially amended in 2005 to incorporate the European Union (EU) Market Abuse Directive.[10] Thus, the UK insider dealing regime, which now falls within the broad rubric of "market abuse", is influenced substantially by the EU-wide framework.

As required by the FSMA, the Financial Conduct Authority ("FCA") has issued the Code of Market Conduct ("MAR 1"),[11] which sets out guidance to determine whether particular types of behaviour amount to market abuse. This also provides for certain "safe harbours" whereby specific conduct in relation to information disclosure and dealing will not be treated as market abuse. Supplementing these are the Disclosure and Transparency Rules ("DTR")[12] issued by the UK Listing Authority ("UKLA") that seek to ensure transparency in the stock markets and proper access to corporate information.

This regime is currently undergoing change. The EU MAD is being replaced by a new EU Market Abuse Regulation ("EU MAR"),[13] which was approved in 2014. The EU MAR will come force on 3 July 2016 and, unlike its predecessor, will be directly applicable in the member states from that date. Although MAR 1 may be withdrawn once the EU MAR comes into effect, commentators find similarities between the existing UK regime and the EU MAR, due to which it is hoped that the practice that has developed through MAR 1 will continue to be relevant for the future.[14]

---

[10] Directive 2003/6 of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96).

[11] Financial Conduct Authority, *FCA Handbook: MAR 1 The Code of Market Conduct*, available at https://www.handbook.fca.org.uk/handbook/MAR/1.pdf.

[12] Financing Conduct Authority, *DTR Disclosure Rules and Transparency Rules*, available at https://www.handbook.fca.org.uk/handbook/DTR/.

[13] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on Market Abuse, 2014 O.J. (L173). This repeals the EU MAD. Along with this, a new Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on Criminal Sanctions For Market Abuse (Market Abuse Directive), 2014 O.J. (L173) was issued, although the UK has opted out of this new criminal sanctions regime. Martin Sandler, et. al., *Market Abuse*, (2014) 118 Compliance Officer Bulletin 1.

[14] Mark Bardell, et. al. (eds.), *Butterworths Takeovers: Law and Practice*, 2nd edn (London, LexisNexis, 2015) at 231.

In Singapore, insider trading is regulated through primary legislation by way of the Securities and Futures Act.[15] The Singapore framework is derived largely from Australian law, which is considered to be among the strictest insider trading regimes in the world.[16] Enforcement against insider trading is considered to be strong in Singapore, with several actions brought by the regulatory authority.[17] In India, the regime is governed by subordinate legislation issued by the Securities and Exchange Board of India ("SEBI") in the form of the SEBI (Prohibition of Insider Trading) Regulations 2015 ("SEBI Regulations"). Although the proscription against insider trading was introduced in 1992,[18] the framework was recently reformed due to a perceived lack of effectiveness.[19]

Despite some differences in the regulatory framework, these jurisdictions adopt a common policy stance towards insider trading, to which the paper now turns.

B. "Parity of Information" Approach

Each of these jurisdictions provides for two types of offences. The first is a "communication" offence whereby an insider would be held liable for disclosure of inside information, except in certain circumstances (usually when it is in the proper course of the person's employment, profession or duties).[20] Therefore, in a due diligence exercise, the management of the target may be committing the communication offence by disclosing inside information to the acquirer. The second is a "trading" or "dealing" offence whereby an insider trades or deals on the basis of (or while in possession of) inside information.[21] If the acquirer obtains inside information through the due diligence process and completes the acquisition without disclosing that information to the market, the acquirer would have committed the trading or dealing offence. The fact that both the target's management as well as the acquirer could be treading dangerously from a regulatory framework makes the due diligence exercise in a public listed company rather complicated.

---

[15] Cap 289, 2006 Rev. Ed.

[16] Wan Wai Yee, "Singapore's Insider Trading Prohibition and its Application to Take-over Transactions", (2007) 28(4) Company Lawyer 120 at 120.

[17] See Hans Tjio, *The Principles and Practice of Securities Regulation in Singapore*, 2nd ed. (Singapore: LexisNexis, 2011).

[18] SEBI (Prohibition of Insider Trading) Regulations 1992.

[19] Securities and Exchange Board of India, Report of the High Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992 Under the Chairmanship of N.K. Sodhi (7 December 2013), available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1386758945803.pdf.

[20] FSMA, s. 118(3) (UK); Securities and Futures Act, ss. 218(3), 219(3) (Singapore); SEBI Regulations, reg. 3 (India).

[21] FSMA, s. 118(2) (UK); Securities and Futures Act, ss. 218(2), 219(2) (Singapore); SEBI Regulations, reg. 4 (India).

Furthermore, all three jurisdictions adopt a strict approach towards insider trading, which is premised on the "parity of information" theory. Under this 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."[22] In other words, the wrong is one of strict liability and it does not matter whether the person trading has a blameworthy state of mind.[23] This substantially expands the scope of the insider trading regime, and brings within its fold even individuals who may have received inside information accidentally. Contrast this with a narrower approach followed in the United States (US) where liability arises only if the person trading owes a fiduciary duty to the company and its shareholders,[24] which has subsequently been extended to a duty owed to the source of the information.[25] The US has expressly rejected the "parity of information" theory.[26]

The strict nature of the insider trading violation is evident from the regulatory experience in the three jurisdictions. In the UK, although the FSMA provides in section 118(1) that the insider should have dealt with "on the basis of" inside information, in actual practice the distinction between knowing use of the information on the one hand and its mere possession on the other hand is blurred. In interpreting the MAD, on which the FSMA is premised, the European Court of Justice (ECJ) held that where an insider has dealt in securities while in possession of inside information, a presumption is triggered that the person "used that information" in the dealing, although that presumption is a rebuttable one.[27] The Court also found that any reference to a mental element would weaken the preventive mechanism for insider trading.[28] Even within the UK, MAR 1 clarifies that market abuse does not require the person engaging in behaviour in question to have intended to commit the same.[29] The strict nature of the UK approach is evidenced further in a case where an insider was fined by the Financial Services Authority (FSA)[30] for

---

[22] Edward Greene & Olivia Schmid, "Duty-Free Insider Trading?", [2013] Columbia Business Law Review 369 at 370.

[23] Alexander F. Loke, "From the Fiduciary Duty Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore, (2006) 54 American Journal of Comparative Law 123 at 147.

[24] Known as the "classical theory", this was set forth in *Chiarella v United States*, 445 U.S. 222 (1980).

[25] Known as the "misappropriation theory", this was set forth in *United States v O'Hagan*, 521 U.S. 642 (1997).

[26] *Chiarella v United States*, 445 U.S. 222 (1980).

[27] *Spector Photo Group NV v Commissie voor het Bank-, Financie-en Assurantiewezen* (CBFA) (C-45/08) [2010] All E.R. (EC) 278; [2010] 2 C.M.L.R. 30 at [54].

[28] *Spector Photo Group NV v Commissie voor het Bank-, Financie-en Assurantiewezen* (CBFA) (C-45/08) [2010] All E.R. (EC) 278; [2010] 2 C.M.L.R. 30 at [37].

[29] MAR 1, 1.2.3 G.

[30] The FSA is the predecessor of the FCA.

disclosing inside information regarding a possible takeover although the recipients of the information did not trade in the shares.[31]

The use of the strict approach is apparent in India as well. Although the initial version of the SEBI Regulations in 1992 carried the language of "on the basis of" similar to the FSMA, that was subsequently amended to reflect that mere possession of inside information is sufficient for purposes of insider trading.[32] The Securities Appellate Tribunal hearing appeals from SEBI on securities law issues had been adopting a stance similar to the ECJ whereby a person in possession of inside information is presumed to have traded "on the basis of" such information, unless proved to the contrary.[33] This principle is now entrenched explicitly in the 2015 version of the regulations.[34] Singapore too adopts the position whereby it is not necessary to prove the intention of the person towards use of such information.[35] In addition, in the case of a "connected person", there is a presumption that a person in possession of inside information knew that it was inside information and that it was price sensitive.[36] In case of outsiders such as "tippees", the presumption is unavailable.

The "parity of information" approach places significant barriers on the conduct of acquisition due diligence. Upon completion of the process, if an acquirer trades while in possession of inside information, it could be in violation of the insider trading regulations. It does not matter that the acquirer lacked the intention to violate the law. The acquirer's intention and motive are irrelevant, and whether the transaction benefits the company as a whole, including the shareholders, is beside the point. The target's management could be in breach as well by disclosing the information during due diligence. Hence, a strict application of the "parity of information" theory would render a due diligence exercise in a listed company almost impossible. In order to mitigate the rigidity of this theory, there have been gradual incursions into the same whereby limitations have been introduced so as to meet with evolving business and commercial

---

[31] FSA Decision Notice, *Ian Charles Hannam* (27 February 2012); *Ian Charles Hannam v The Financial Conduct Authority*, Appeal number FS/2012/0013 (27 May 2014). See Edward Greene & Olivia Schmid, "Duty-Free Insider Trading?", [2013] Columbia Business Law Review 369 at 395-396.

[32] SEBI (Insider Trading) (Amendment) Regulations, 2002. In a case that related to the legal position prior to the amendment, the Securities Appellate Tribunal refused to sustain an insider trading charge against a person who did not possess the intention of gaining any unfair advantage and had instead acted in the interest of the company. *Rakesh Agarwal v. Securities and Exchange Board of India*, [2004] 49 SCL 351 (SAT).

[33] *Chandrakala v Adjudicating Officer, Securities and Exchange Board of India*, Securities Appellate Tribunal (31 January 2012).

[34] SEBI Regulations, reg. 4(1), note.

[35] Securities and Futures Act, s. 220.

[36] Securities and Futures Act, s. 218(4).

circumstances.[37] In this "limited parity of information theory", selective disclosure can be justified so long as certain conditions are satisfied.[38]

From a theoretical standpoint, it is possible to rationalise due diligence in share acquisitions under such a "limited parity of information" theory. While due diligence results in selective disclosure to the acquirer on a temporary basis, neither the other shareholders of the target are adversely affected nor is market integrity compromised if the inside information is channeled into the public domain before the acquirer proceeds with the acquisition. Due diligence only provides the acquirer with the opportunity to decide whether to proceed with the acquisition (or not) and to define the terms of such acquisition. If the transaction proceeds, parity of information is restored through appropriate pre-acquisition disclosures of any inside information as well as the terms of the transaction. If it does not proceed, no harm is suffered as no trading or dealing takes place in the shares of the target. In either event, the acquirer will be prohibited from buying or selling shares of the target other than through the transaction under consideration.

Within this theoretical framework, the paper proceeds to consider the specific types of transactions where due diligence is undertaken and how that is dealt with under the insider trading regime, both generally and within the specific jurisdictions under study.

III. Share Acquisitions Through Takeover Offers

In the first type of transaction, the acquirer conducts due diligence with a view to making a takeover offer to the other shareholders of the target. Given that a takeover offer requires significant disclosure of information to the target's shareholders and that equal treatment must be meted out to all shareholders, including by offering them the same price,[39] the justification for performing a due diligence is understandable. If due diligence is necessary to motivate acquirers to make takeover offers that may be attractive to the target's shareholders, disallowing due diligence will cause detriment to those shareholders. Among the different types of share acquisitions, the rationale for due

[37] For example, under a somewhat different scenario involving the "mosaic theory", an analyst is entitled to put together pieces of public information to arrive at a material conclusion using the analyst's own skill and diligence. Alexander F. Loke, "From the Fiduciary Duty Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore, (2006) 54 American Journal of Comparative Law 123 at 156; Edward Greene & Olivia Schmid, "Duty-Free Insider Trading?", [2013] Columbia Business Law Review 369 at 412.

[38] In some jurisdictions, such selective disclosures are permitted if they are required in the proper course of exercise of employment, profession or duties (see FSMA, s. 118(3)) or it is in furtherance of legitimate purposes performance of duties or discharge of legal obligations (SEBI Regulations, reg. 3(1)).

[39] Reinier Kraakman, et. al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed. (Oxford: Oxford University Press, 2009) at 226.

diligence operates the strongest in takeovers. Consistent with this, all of the jurisdictions examined in this paper allow for due diligence to be carried out in transactions involving takeovers. However, they vary in the details of the regulatory framework, and also carry inadequacies that need to be addressed, as discussed below. Moreover, the legislative frameworks in all three jurisdictions are unclear as to whether the mere fact of a takeover offer would justify due diligence, or whether it must be accompanied by a cleansing announcement before acquiring shares under the offer.

A. Due Diligence Followed by a Takeover Offer

The legislative framework for insider trading overlaps in this area with that for takeover regulation. Both in the UK and Singapore, the Takeover Codes lay down the general rule of parity of information whereby information regarding the target and other parties involved in the takeover must be provided equally and simultaneously to all shareholders of the target.[40] However, both systems expressly recognise the need for the target to provide information in confidence to the acquirer,[41] presumably through the due diligence process. In order to ensure equality among acquirers, any information provided to one potential acquirer must also be furnished equally and promptly to the other offerors as well.[42] However, the other offerors are entitled to equal information only in response to specific questions.[43] This mechanism provided for in the takeover regulation in the UK and Singapore is explicit recognition of the fact that due diligence is permitted in case of a takeover offer.

In the UK, the regime relating to market abuse and insider trading defers to takeover regulation when it comes to information sharing in the context of a takeover offer. For example, MAR 1 provides for a safe harbour from insider dealing whereby dealing based on inside information in the context of a public takeover offer (or merger) will not amount to market abuse, which includes information obtained by the acquirer through due diligence.[44] Similarly, MAR 1 enables the acquirer to seek irrevocable undertakings or expressions of support from the target's shareholders, which may involve selective disclosure of its potential offer to them. All of these entitle the acquirer to carry out due diligence before launching a takeover offer.

---

[40] The Takeover Code, r. 20.1 (UK); The Singapore Code on Take-overs and Mergers, r. 9.1.

[41] The Takeover Code, r. 20.1, n. 1 (UK); The Singapore Code on Take-overs and Mergers, r. 9.1, n. 1.

[42] The Takeover Code, r. 20.2 (UK); The Singapore Code on Take-overs and Mergers, r. 9.2.

[43] The Takeover Code, r. 20.2, n. 1 (UK); The Singapore Code on Take-overs and Mergers, r. 9.2.

[44] MAR 1, 1.3.17C; 1.3.18G. The FCA draws this power to provide a safe harbour in MAR 1 from the FSMA, s. 120(1). See also, *Ian Charles Hannam v The Financial Conduct Authority,* Appeal number FS/2012/0013 (27 May 2014) at [146].

In Singapore, the relationship between the insider trading regime and the Takeover Code is somewhat tenuous. Unlike in the UK, the Securities and Futures Act does not provide for an express safe harbour for information disclosures in a takeover offer.[45] Hence, if inside information is received during due diligence, an acquirer may be in violation of the legislation if it acquires shares in the takeover offer, as it will be committing the "trading" offence.[46] Similarly, the target may be committing the "communication" offence by disclosing information during due diligence.[47] To that extent, the regime in Singapore may disallow acquirers from proceeding with the offer unless they make a public disclosure of any inside information received by them during due diligence.[48] Alternatively, it can be argued that since the Securities and Futures Act constitutes the composite legislation that provides for the insider trading regime and also forms the source for the takeover regime,[49] a harmonious construction of its provisions should by implication make the safe harbour (similar to that in the UK) available to acquirers making takeover offers in the Singapore context. However, this position lacks clarity, and it would be desirable for the legislation to be amended to provide for an express safe harbour.

The regulatory framework in India on this count is clear. The target is entitled to disclose inside information to the acquirer so long as the acquisition results in a takeover offer.[50] The rationale for this approach is explained in a note to the SEBI Regulations, indicating that the equal treatment to all shareholders in a takeover offer and the availability of all necessary information to enable them to make an informed divestment decision would protect the target's shareholder interests.[51] However, this safe harbour is available only in relation to the "communication" offence and not the "trading" offence, which would leave the acquirer vulnerable to a violation if it proceeds with the acquisition without first making the inside information publicly available.

This leads to the broader analysis of due diligence and insider trading in the context of a takeover offer. As this paper has sought to articulate, the limited parity of information theory accommodates due diligence and selective disclosure of information so long as the acquirer makes a cleansing announcement before it acquires shares in the offer. Such a public disclosure of inside information can be made either in the public announcement

---

[45] However, the Singapore Exchange (SGX) Mainboard Rules, Appendix 7.1 at [24] permits selective disclosures in limited instances such as "due diligence when the issuer is the subject of an acquisition".

[46] Securities and Futures Act, ss. 218(2), 219(2) (Singapore).

[47] Securities and Futures Act, ss. 218(3), 219(3) (Singapore).

[48] Wan Wai Yee & Umakanth Varottil, *Mergers and Acquisitions in Singapore: Law and Practice* (Singapore: LexisNexis, 2013) at [16.70].

[49] The Securities and Futures Act, s. 139 provides the legislative basis for the Takeover Code.

[50] SEBI Regulations, 3(3)(i).

[51] SEBI Regulations, 3(3)(i), note.

when the offer is launched, or subsequently when the letter of offer is sent to the shareholders. At the same time, it is not necessary that all information obtained by the acquirer during due diligence must so be disclosed publicly. It is only inside information that is price sensitive in nature that needs to be contained in the cleansing announcement. Commonly, information such as a summary of projections given to the acquirer during due diligence could potentially require public disclosure, while technical or financial information relating to individual units of the target or other internal statements and accounts may not be considered material enough to be disclosed.[52] In addition, cleansing announcements may be fraught with difficulties even in friendly transactions when there are disagreements between the acquirer and the target as to what information must be disclosed, especially when it relates to sensitive issues pertaining to the business of the company, such as information that might be valuable to a business competitor.

While takeover regulation does provide for a detailed list of information to be disclosed in the offer documents,[53] nowhere does it require specific inside information obtained during due diligence to be disclosed if it does not fall within the list of stipulated information to be contained in the offer documents. To that extent, the legal regime in these three jurisdictions have not satisfactorily addressed the concern that the "parity of information" theory raised in the context of due diligence. This gap between legislation and its theoretical underpinnings could give rise to significant issues in implementation of the legal regime on insider trading, as evident from the experience in these jurisdictions.

This controversy arose in *Spector Photo Group NV v Commissie voor het Bank-, Financie-en Assurantiewezen* (CBFA),[54] wherein the ECJ referred to the 29th recital of the EU MAD which provides for a safe harbour whereby having access to inside information and using it in the context of a public takeover offer with a view to gaining control of the target will not amount to insider dealing. It further observed that the:

> "operation whereby an undertaking, after obtaining inside information concerning a specific company, subsequently launches a public takeover bid for the capital of that company at a rate higher than the market rate cannot, in principle, be regarded as prohibited insider dealing since it does not infringe the rights protected by [EU MAD]".[55]

---

[52] Philip Richter & David Shine, "A Practical Approach to Negotiating Confidentiality Agreements in the Corporate Acquisition Context", (2013) 17(9) The M&A Lawyer, available at http://www.friedfrank.com/index.cfm?pageID=25&itemID=6821&fontsize=1.

[53] The Takeover Code, rr. 24, 25 (UK); The Singapore Code on Take-overs and Mergers, rr. 23, 24; SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, regs. 15, 16.

[54] (C-45/08) [2010] All E.R. (EC) 278; [2010] 2 C.M.L.R. 30 at [56], [59].

[55] *Spector Photo Group NV v Commissie voor het Bank-, Financie-en Assurantiewezen* (CBFA) (C-45/08) [2010] All E.R. (EC) 278; [2010] 2 C.M.L.R. 30 at [56], [59].

At the outset, the ECJ proceeds on the assumption that the mere fact of a takeover offer is sufficient to attract the safe harbour. In other words, there is no requirement imposed on the acquirer to make a cleansing announcement. Hence, parity of information is not restored, as assumed in the framework established earlier in this paper. It has been suggested that the safe harbour in the 29th recital only provides for a safe harbour from the presumption regarding "use" of the information, and that the regulator could very well be entitled to prove that the acquirer "used" the inside information in order to acquire shares in the offer.[56] To that extent, the safe harbour is of limited application.

Even more intriguing is ECJ's reference to the fact that the safe harbour will be triggered if the takeover bid is at a "rate higher than the market rate". First, no pricing requirement has been stipulated in the EU MAD itself, and hence this requirement is introduced by implication by the Court. Second, market price does not determine the use of inside information by the acquirer one way or the other. Let us examine this through an illustration. Take the case of a target T, whose shares are trading at £10 per share. Finding that T's shares are undervalued, acquirer A approaches T's management to make an offer at £15 per share, i.e. at a 50% premium to market price, subject to the findings of due diligence. If A obtains certain negative findings during due diligence due to which it finally negotiates with T's management a price of £12 at which the offer is launched, the safe harbour provided for by the ECJ in *Spector Photo Group NV* continues to operate as the offer price is higher than the market price. However, is the limited "parity of information" approach diluted? Yes, because the inside information based on which A arrived at its decision to make a takeover offer at £12 is not available to the other shareholders. This would be possible only if there is a requirement on T to include its due diligence findings that are price sensitive in nature in its disclosure to T's shareholders.

Although the present position in the three jurisdictions lack clarity on the disclosures to be made by the acquirer in order to avail of the due diligence safe harbour, the reform efforts culminating in the EU MAR have squarely addressed this concern. Paragraph 4 of article 9 states:

> … it shall not be deemed from the mere fact that a person is in possession of inside information that that person has used that information and has thus engaged in insider dealing, where such person has obtained that inside information in the conduct of a public takeover or merger with a company and uses that inside information solely for the purpose of proceeding with that merger or public takeover, provided that at the point of approval of the merger or acceptance of the offer by the shareholders of that company, any inside information has been made

[56] Christian Cascante & Adrian Bingel, ""Using" inside information: the ECJ's ruling on insider dealing and its implications for M&A", (2010) 25(9) Journal of International Banking Law and Regulation 464.

> public or has otherwise ceased to constitute inside information. [Emphasis supplied]

This dispensation adheres closely to the limited "parity of information" as discussed in this paper as it permits a safe harbour for due diligence, but limits the acquirer from "using" the inside information without prior disclosure. In this case, any information asymmetry is only temporary and parity is restored before trading occurs.

Given this discussion, this paper argues that the EU MAR provision discussed above constitutes a useful model for due diligence in a takeover offer context that other jurisdictions may adopt as well, as it is not only reasonable to the target's shareholders but is also consistent with the theoretical foundations of the insider trading regime in jurisdictions such as the UK, Singapore and India.

This conclusion is, however, based on the fact that the legal regime prohibits acquirers in possession of inside information obtained through due diligence from acquiring the shares of the target other than through the takeover offer, or from selling shares it already holds, which is now examined.

B. Due Diligence and Stakebuilding

An acquirer rarely makes a takeover offer without first purchasing a sizeable stake in the target. This process of acquiring shares in the target either on the markets or off it, but outside of a takeover offer, is referred to as "stakebuilding".[57] If an acquirer engages in stakebuilding after commencement of due diligence and once it in possession of inside information, then it would stand in violation of the insider trading laws. This is a common theme that runs through all the three jurisdictions, as the acquirer would have committed the "trading" offence.

In the UK, the Takeover Code expressly deals with this situation by providing that an acquirer will be prevented from dealing in the shares of the target before the announcement of an offer if it in possession of inside information.[58] The new EU MAR is also explicit on this count as it clarifies that the safe harbour provided for due diligence disclosures in case of public takeover or a merger is not available for stakebuilding.[59] The legal framework in Singapore and India do not deal explicitly with stakebuilding while in

---

[57] Raj Panasar & Philip Boeckman (eds.), *European Securities Law*, 2nd ed. (Oxford: Oxford University Press, 2014) at 298. See also, Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on Market Abuse, 2014 O.J. (L173), art. 3(31). This is also sometimes referred to as a "toehold" acquisition.

[58] The Takeover Code, r. 20.1 (UK), n. 1 to rr. 4.1, 4.2.

[59] EU MAR, art. 9(4).

possession of inside information gathered during due diligence, but this raises less of a concern as the activity falls within the general insider trading prohibition.

Given this strict scenario, acquirers must refrain from a stakebuilding exercise when they have obtained inside information from the target. Any stakebuilding must take place prior to commencement of the due diligence so that the acquirer is not in possession of inside information at that stage.

Although the legal regime relating to stakebuilding and information obtained through due diligence is a straightforward one, it is nevertheless a crucial piece of the framework. This is because the safe harbour for due diligence in takeover offers is premised upon the fact that the acquirer will only act pursuant to the due diligence findings by acquiring shares in the takeover offer and not outside of it.

C. Stakebuilding with Intention to Offer

A final aspect relating to takeover offers is whether the acquirer's intention to make the offer would itself constitute inside information that would prevent the acquirer from stakebuilding. Theoretically speaking, if the acquirer does not have any inside information from the company through due diligence (or otherwise), then its own knowledge or intention regarding a possible offer it might make in the future should not prevent it from trading in the shares of the company. If such trading is prohibited, then stakebuilding, which may otherwise motivate acquirers to proceed to then make a takeover offer, will not be available to acquirers. This may have the effect of chilling the market for takeovers.

Both the UK and Singapore provide for specific safe harbours. In the UK, the Criminal Justice Act 1993 provides that a person is not guilty of insider dealing in certain circumstances where the information of the insider relates to its own involvement in the transaction.[60] Under the civil regime, MAR 1 clarifies that carrying out one's own intention does not amount to insider dealing.[61] This position is further affirmed by relevant provisions in the Takeover Code, which prohibit dealings by persons other than the acquirer if they are privy to information regarding a possible offer.[62] However, this

[60] Criminal Justice Act 1993, schedule 1, para. 3 (UK).
[61] MAR 1, 1.3.6C.
[62] Takeover Code, r. 4.1 (UK).

prohibition does not extend to the acquirer itself, who is free to acquire based on its own intention.[63]

The position in Singapore is quite clear. The Securities and Futures Act contains an express safe harbour that excludes acquirers from the insider trading prohibition while it has knowledge of its own previous transactions or intended transactions.[64] Similar to the UK, the Takeover Code in Singapore proscribes only persons other than the acquirer from trading while in possession of the knowledge of the acquirer's intentions.[65] In India, the SEBI Regulations do not carry a safe harbour provision, which leaves some uncertainty. Given the strict approach followed by the Indian insider trading regime, the regulator may be able to argue that the presumption of insider trading applies, which the acquirer will be required to rebut. This uncertain state of affairs ought, however, to be rectified through suitable amendments in the SEBI Regulations to introduce a safe harbour similar to that in the UK and Singapore.

After examining the various considerations relating to due diligence in transactions involving takeover offers, it would be necessary to look at the regime relating to share acquisitions that do not result in takeover offers.

III. Share Acquisition: Minority Stake Without Takeover Offers

It is quite common for acquirers to take up a significant minority shareholding in target companies. This is possible through a secondary market transaction such as a block-trade whereby an acquirer acquires shares from an existing shareholder through the stock exchange. Alternatively, the trade can be effected outside the stock exchange through a negotiated transaction. However, the more prominent types of acquisitions that do not entail a takeover offer relate to investments by acquirers directly into the target in exchange for new shares in the form of a private placement. Such transactions involving public listed companies, being the subject matter of this paper, are commonly referred to as private investment in public companies (PIPE).[66] In these transactions, although the acquirer does not obtain control over the target, its minority investment is significant enough in terms of financial risk for it to embark upon due diligence over the target prior to completion of the transaction. Moreover, unlike takeovers, private placements give rise

---

[63] Mark Bardell, et. al. (eds.), *Butterworths Takeovers: Law and Practice*, 2nd edn (London, LexisNexis, 2015) at 275.

[64] Securities and Futures Act, ss. 228, 229 (Singapore).

[65] Singapore Code on Take-overs and Mergers, r. 11.1.

[66] Alan J. Berkeley, "PIPEs Hedging Under Scrutiny", American Law Institute – American Bar Association Continuing Legal Education SS031 ALI-ABA 751 (17-19 March 2011); Douglas J. Hoffer, "Quagmire: Is the SEC Stuck in a Misguided War Against PIPE Financing?", (2011) Transactions: The Tennessee Journal of Business Law 9.

to additional complexities given that they are usually initiated by the target approaching a number of investors to gauge their interest in investing, a phenomenon referred to as "market-sounding".[67] Such an approach while the information regarding the possible private placement is not publicly available could lead to insider trading concerns. This Part considers both due diligence in relation to a private placement and the prior approach by the target to investors.

A. Due Diligence in Private Placement or Block Trade

In the case of an acquisition not involving a takeover offer, the benefits to the minority shareholders is not clear, and may vary from transaction to transaction. Unlike in a takeover offer, there is neither significant disclosures made to the target's shareholders nor do they obtain the opportunity to participate in the transaction or even exit the company. Due diligence in such an acquisition solely benefits the acquirer. For this reason, there is no justification for the acquirer to be able to effect the transaction while it has inside information about the target. The only manner in which the acquirer can proceed with the transaction is by ensuring that any inside information it has obtained during due diligence is placed in the public domain beforehand through a cleansing announcement.[68]

All three jurisdictions examined here are categorical in that an acquirer cannot engage in a block trade or private placement while in possession of inside information obtained through due diligence as it contravenes the basic insider trading provisions operating under the "parity of information" theory. Hence, even where the acquirer conducts due diligence, it will have to undertake a cleansing exercise before it in fact acquires the shares of the target. While this is understandable and justifiable from a theoretical standpoint, it could give rise to significant practical concerns. For example, it might be compelled to disclose information that is sensitive in nature from a competitive perspective. If the target is in the process of negotiating a significant contract, it might have to advance its disclosure although the process has not yet attained the level of certainty that might normally mandate disclosure.[69] Moreover, often the acquirer may have no way of assessing whether information provided to it under the due diligence process is inside information that is price-sensitive in nature.

---

[67] EU MAR, recital (33).

[68] Wan Wai Yee & Umakanth Varottil, *Mergers and Acquisitions in Singapore: Law and Practice* (Singapore: LexisNexis, 2013) at [16.70]; Linklaters, "FSA penalties reinforce need for caution when wall-crossing" (February 2012).

[69] One practical way of addressing this concern is to time block trades or private placements to coincide with or come shortly after an earnings announcement when all relevant information is to be put out in the public domain.

While the trading offence can be avoided by ensuring timely cleansing, there is less clarity on whether the target's management commits the communication offence by providing due diligence. In the UK, in the absence of a specific safe harbour similar to takeover offers, it would be necessary to rely upon general provisions that permit selective disclosures in certain circumstances. The FSMA contains an exception whereby the communications offence does not apply if disclosure by a person is "in the proper course of the exercise of his employment, profession or duties".[70] While the scope and ambit of this exception is discussed in greater detail in the next Part, it is useful to note that MAR 1 contains an explanation regarding this exception and, among other things, takes into account the fact that the disclosure is made by the person "only to the extent necessary, and solely in order, to … acquire the investment from, the person receiving the investment".[71] Although this provision contemplates the scenario involving a private placement for which selective disclosures may be made, it is important to note that this provision only requires the regulators or courts to take this into account as a factor while considering the evidence as a whole. It is not a safe harbour provision similar to the one available for takeovers, and hence lacks conclusiveness. Moreover, since it refers to investments into the company, it encompasses only private placements and not block trades.

The Singapore regime adopts a strict approach to disclosures in non-takeover offer situations. The communication offence is absolute and is not accompanied by any safe harbours or provisions that allow selective disclosures by the target's management.[72] It has been argued that the management should be able to disclose inside information to an acquirer so long as the latter is bound not to disclose or trade on that information. However, given that this is not expressly stated in the statute, such an interpretation is not free from doubt.[73] Given the over-inclusive nature of the communications offence, calls have been made to amend the Securities and Futures Act in Singapore to provide for specific exceptions that allow selective disclosures (such as through due diligence) under controlled circumstances.[74]

---

[70] FSMA, s. 118(3). This position is preserved in the EU MAR, art. 11.

[71] MAR 1, 1.4.5E(3)(b). Such a disclosure must be accompanied by certain protective measures that includes obtaining an undertaking from the recipient not to disclose the inside information or trade in shares while it is unpublished.

[72] However, the Singapore Exchange (SGX) Mainboard Rules, Appendix 7.1 at [24] permits selective disclosures in for "due diligence when the issuer is the subject of an acquisition". Furthermore, there is an exception from insider trading restrictions for underwriters purchasing or selling securities pursuant to their underwriting obligations. Securities and Futures Act, ss. 218(3), 219(3) (Singapore), s. 223.

[73] Wan Wai Yee, "Singapore's Insider Trading Prohibition and its Application to Take-over Transactions", (2007) 28(4) Company Lawyer 120 at 123.

[74] Wan Wai Yee, "Singapore's Insider Trading Prohibition and its Application to Take-over Transactions", (2007) 28(4) Company Lawyer 120 at 123.

The regime in India is the most categorical for transactions not involving takeover offers. It permits due diligence on the condition that inside information obtained during the process "is disseminated to be made generally available at least two trading days prior to the proposed transaction being effected in such form as the board of directors may determine."[75] It considers the need for due diligence as a practical reality and seeks to embrace it expressly and provides for a "predictable, clear and conditional framework" for the same.[76] Although the intent of the regulator is clear, there could be issues surrounding the implementation of this framework as the form and manner of dissemination of information is left to the board. While that provides sufficient flexibility to determine disclosure requirements depending on the circumstances, it also lacks the required regulatory clarity.[77]

B. Market-Sounding

Private placement transactions given rise to a peculiar issue. Unlike takeovers that are typically initiated by the acquirer,[78] capital raising exercises through private placements are generally initiated by the target, which may first approach a few potential investors to determine whether there is interest in investing in the target's shares. Such a market-sounding effort may itself give rise to insider trading concerns because the company's intention to raise further capital may be inside information.[79] Depending upon the nature and circumstances of the private placement, that information could have a significant impact on the market price of the target. For instance, if the company is raising capital to deploy into a new business with growth potential, investors may consider that to be positive information that drives up the share price of the company, and hence motivates persons with that information to buy more shares in such a target. On the contrary, if the capital raising is for the purpose of retiring existing debt, that may have a negative

---

[75] SEBI Regulations, reg. 3(3)(ii).

[76] Securities and Exchange Board of India, Report of the High Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992 Under the Chairmanship of N.K. Sodhi (7 December 2013), available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1386758945803.pdf at [49].

[77] Aparna Ravi, "Insider Trading and the Risks of Due Diligence Access", IndiaCorpLaw Blog (22 January 2015), available at http://indiacorplaw.blogspot.co.uk/2015/01/insider-trading-and-risks-of-due.html.

[78] However, it is also possible at times that a significant blockholder of a target may approach potential acquirers who may then trigger a mandatory takeover offer by purchasing that block.

[79] Some may take the view that a private placement is a transaction between the company and the acquirer who both have the same level of information following the transaction, and that since there is no other counterparty (such as an outside shareholder) who trades with the acquirer, insider trading concerns should not operate in private placements. However, while this view is understandable, insider trading issues should nevertheless arise because the acquirer has an informational advantage compared to the other shareholders, which falls on the face of the "parity of information" theory and the fundamentals of market integrity that are inherent in the regulation of insider trading.

impact, thereby motivating existing shareholders to sell their shares, or short them.[80] Their desire to sell is buoyed by the dilution they will suffer in a private placement.[81]

Among the jurisdictions examined, the UK is the only one that has devised and implemented a detailed framework for market-sounding. As previously discussed, the UK legal regime allows selective disclosures by the target's management if that is in the proper course of their exercise of employment, profession or duties.[82] A disclosure in connection with potential investment into the company is one such scenario. However, such a disclosure must be accompanied by the imposition of strict confidentiality requirements on the recipient of inside information that prevents such person from either disclosing that information or trading in the shares of the target. Such a process is referred to as "wall-crossing" whereby the target selectively discloses information to an outsider in return for a promise not to disclose or trade, effectively forcing the recipient to cross the wall and become an insider.[83]

The FCA and its predecessor, FSA, have rigorously enforced the market-sounding regime. In an early action, a mutual fund manager who had been wall-crossed and was disclosed information about a potential deal regarding a target was fined £750,000 when he nevertheless proceeded to trade in the target's shares.[84] The case that received the highest attention relates to David Einhorn, upon whom the FSA imposed a penalty of £3,638,000.[85] Einhorn was the owner and sole portfolio manager of Greenlight Capital, Inc., a hedge fund that had invested in a stake of 13.3% in Punch Taverns, a UK-listed company. Punch, through its investment banker, approached Greenlight in relation to a potential equity issuance and asked for Greenlight to be wall-crossed. Although Einhorn refused to be wall-crossed, he nevertheless went ahead with a telephone conference call with Punch's CEO and obtained information regarding the equity issuance, which included the fact that Punch was at an advanced stage of issuing new equity, probably within a week, for the purpose of repaying convertible bondhonders. Immediately following the call, Einhorn directed Greenlight's traders to sell Punch shares, due to

---

[80] For example, see FSA Final Notice, *David Einhorn* (15 February 2012).

[81] Empirical evidence suggests widespread evidence of pre-private placement short sales when hedge funds are involved. Henk Berkman, Michael D. McKenzie & Patrick Verwijmeren, "Hole in the Wall: Informed Short Selling Ahead of Private Placements" (16 October 2013), available at http://ssrn.com/abstract=2233757, at 4.

[82] FSMA, 118(3); MAR 1, 1.4.5E.

[83] Carlos Conceico, "Wall crossing – Walking the regulatory tightrope", Clifford Chance Client Briefing (September 2014), available at http://www.cliffordchance.com/briefings/2014/09/wall_crossing_-_walkingtheregulatorytightrope.html.

[84] FSA Final Notice, *Philippe Jabre* (1 August 2006). A similar situation arose in Hong Kong where a wall-crossed investor had traded while in possession of inside information, and was accordingly charged. Market Misconduct Tribunal, Hong Kong, *In the Matter of the Listed Securities of Bank of China Limited and China Construction Bank* (11 July 2013).

[85] FSA Final Notice, *David Einhorn* (15 February 2012).

which its holding was reduced to 8.98%. FSA found a violation since sufficient information was conveyed to Einhorn on the call that enabled him to draw a conclusion regarding a possible negative impact on the share price of Punch, which he avoided by selling shares before the information was available to the market. This heralded an era of strict enforcement of insider trading regulation by the FSA.

These developments have only strengthened the regulatory framework surrounding market-sounding. For instance, the EU MAR, while recognising the need for, and importance of, market-sounding, places significant restrictions on the ability of companies to indulge in the same.[86] It provides detailed practical guidance that will enable companies and recipients of information to act with clarity and certainty that would minimise the scope for impinging upon the parity of information. Hence, listed companies as well as investors are now required to have detailed procedures for disclosure of information and wall-crossing.

Although the broad legal principles governing market-sounding are similar in Singapore and India, as they would fall within the broad rubric of the communication and trading offences, the legal regimes in these countries is far from clear. There are no specific rules governing wall-crossing, which makes market-sounding exercises lack certainty from an insider trading perspective. While in the long-term, legislation and rules can be devised to deal with market-sounding mechanisms, in the meanwhile listed companies and investors (particularly institutional investors such as mutual funds and hedge funds) would do well voluntarily establish detailed procedures for wall-crossing, keeping in mind the standards that have evolved in the UK.

V. Conditions for Due Diligence and Disclosure

The legal regime discussed thus far for due diligence in share transactions is premised on the satisfaction of certain important conditions based on which disclosure by a target to the acquirer is permitted. Compliance with these conditions is essential to ensure that the limited parity of information theory is satisfied, which justifies disclosures in due diligence. Although they vary from jurisdiction to jurisdiction, two core conditions stand out. The first is the need for the recipient of inside information to be bound by confidentiality obligations. The second is the requirement for the target's board and management to have arrived at a conclusion that the disclosure of inside information during due diligence was in the interest of the company or was otherwise in discharge of the discloser's profession, employment or duties, thereby rendering legitimacy to the disclosure.

[86] EU MAR, art. 11.

A. Confidentiality Obligation

The target's disclosure of inside information to an acquirer during due diligence is permissible only if the acquirer is bound by confidentiality. This will ensure that the limited parity of information principle is maintained, as the acquirer cannot acquire shares without making a cleansing announcement. The need to impose a confidentiality obligation is an essential element of the selective disclosure in the jurisdictions examined. In the UK, MAR 1 clarifies that the imposition of confidentiality obligations on the acquirer is necessary to seek permissibility of selective disclosures such as during due diligence.[87] Similarly, the regulations in India too are categorical about the need to impose confidentiality obligations on the acquirer for due diligence conducted for an acquisition, whether in relation to a takeover offer or otherwise.[88] The legal framework in Singapore pertaining to insider trading does not impose an express obligation on the target to obtain a confidentiality undertaking from the acquirer, although that could be implied from the overall goals of the insider trading regulation. It is only the stock exchange rules that expressly require imposition of confidentiality constraints.[89] Even though all the three jurisdictions either expressly or implied emphasise confidentiality obligations in the case of due diligence, a number of issues could arise in the application of the rules, which are discussed below. They depend on the nature and extent of the confidentiality agreements parties may enter into.

(1) Non-Disclosure Obligations

The first is a basic requirement of a confidentiality agreement that prohibits the recipient of inside information from disclosing that to any other person. Although such an agreement may be verbal or written, in case of significant transactions such as share acquisitions and takeovers, it is common for the target to enter into a detailed written agreement with the acquirer. This is to prevent a scenario where a person who receives information from an acquirer may trade in the shares of the company and obtain an advantage that erodes the principle of parity of information. Since this is the basic purpose of confidentiality agreements, they generally tend to impose this obligation on the recipient of information.[90] However, from the perspective of insider trading, such an obligation is inadequate on its own and must be accompanied by standstill obligations, which are less commonly found in confidentiality agreements.

---

[87] MAR 1, 1.4.5E(2). The listing framework too permits selective disclosure on the strength of a confidentiality agreement. DTR, 2.5.7G.

[88] SEBI Regulations, reg. 3(4).

[89] Singapore Exchange (SGX) Mainboard Rules, Appendix 7.1 at [24].

[90] Philip Richter & David Shine, "A Practical Approach to Negotiating Confidentiality Agreements in the Corporate Acquisition Context", (2013) 17(9) The M&A Lawyer, available at http://www.friedfrank.com/index.cfm?pageID=25&itemID=6821&fontsize=1.

(2) Standstill Obligations

In addition to non-disclosure obligations, confidentiality agreements may impose two further types of obligations. The first is a "non-use" obligation whereby the acquirer agrees to use the information obtained in due diligence only for the purpose of the transaction under consideration, and for no other. This is typically agreed upon in a negotiated acquisition to preempt the acquirer from launching a hostile takeover offer. The second is a "non-trading" obligation whereby the acquirer agrees not to buy or sell the shares of the target while it is in possession of inside information (and before any cleansing announcement has been made). These types of obligations are commonly referred to as standstill provisions.[91] Since confidentiality agreements tend not to always carry express standstill obligations, courts have had to intervene to determine whether such obligations can be implied. Some US cases are illustrative of these difficulties.

In *Martin Marietta Materials, Inc. v Vulcan Materials Co.*,[92] an acquirer and target entered into confidentiality agreements in relation to a potential merger transaction, which facilitated sharing of information. Although the agreements contained non-disclosure obligations, they did not include standstill provisions. Upon failure of the negotiations for a merger, the acquirer launched a hostile takeover on the target, and included confidential information in the offer documentation. The Delaware Chancery Court interpreted the provision in the agreements that permitted the use of the information solely for the purpose of evaluating the negotiated transaction. In the absence of clarity, it used extrinsic evidence to conclude that the parties intended to use the information only for the consensual transaction. The acquirer was enjoined from proceeding with the hostile takeover for a period of four months, which effectively operated as a standstill provision. A similar conclusion was arrived at by a California court in another case wherein a target was able to succeed in a claim for breach of confidentiality in a hostile takeover although the confidentiality agreement itself was entered into in connection with a past transaction.[93]

Such an issue arose more specifically in the insider trading context in a case involving Mark Cuban where he sold his entire position in the target, Mamma.com, following a telephone call with the target's CEO during which he was informed of a possible PIPE offering. Upon hearing of the potential transaction, Cuban abruptly ended the

---

[91] Wai Yee & Umakanth Varottil, *Mergers and Acquisitions in Singapore: Law and Practice* (Singapore: LexisNexis, 2013) at [4.79].

[92] 56 A.3d 1072 (Del. Ch. 2012), affirmed in *Martin Marietta Materials, Inc. v Vulcan Materials Co.*, 68 A.3d 1208 (Del. SC 2012).

[93] *Depomed, Inc. v Horizon Pharma PLC*, Nos. 1-15-CV-283834, 1-15-CV-283835 (Cal. Sup. Ct. Nov. 19, 2015).

conversation with a remark that he will not be able to sell the shares. He nevertheless went ahead with the disposal. The District Court dismissed the action based on an interpretation of relevant US securities law on the ground that while Cuban had entered into a verbal non-disclosure agreement, he had not agreed to refrain from trading.[94] Here, the Court struck at the distinction between non-disclosure and non-trading, and found the need for both elements to be present for an insider trading action to lie. However, on appeal, the Fifth Circuit found Cuban guilty of insider trading.[95] Although it did not disagree with the District Court with the need for both elements to be present,[96] it found that there were sufficient facts to suggest that Cuban had agreed to both a non-disclosure and not to trade in the target's stock.

The discussion thus far suggests that both in theory as well as in practice, selective disclosure through due diligence must be accompanied by strict confidentiality obligations that include both non-disclosure and standstill obligations. In the absence of specific standstill provisions, the limited parity of information principle will not be satisfied. In the jurisdictions at hand, the evolution of the law seems to be taking cognisance of this. For instance, in the case of market sounding, the EU MAR imposes an express obligation on the target to inform the recipient of inside information that "he is prohibited from using that information, or attempting to use that information, by acquiring or disposing of … financial instruments relating to that information".[97] Similarly, the new insider trading regime in India is clear that due diligence disclosures must be accompanied by both non-disclosure obligations as well as standstill obligation on the acquirer.[98]

The existence of non-disclosure, non-use and non-trading obligations on the acquirer are therefore necessary preconditions for due diligence disclosures by the target. While the jurisdictions differ in the nature and extent to which these obligations are imposed by the disclosure or insider trading regimes, there is merit in requiring those. Even if regulations do not require, it would be advisable for target managements to insist on strict confidentiality agreements including all the three aspects before granting due diligence.

B. Duties of the Target's Directors and Officers

Disclosure of information during due diligence must be allowed only if it is legitimate to do so given individual circumstances. The legitimacy of the disclosure could be justified

---

94 *SEC v Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009)

95 *SEC v Cuban*, 620 F. 3d 551 (5th Cir. 2010).

96 Ryan M. Davis, "Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability", (2010) 63 Vanderbilt Law Review 1469 at 1492.

97 EU MAR, art. 11(5).

98 SEBI Regulations, reg. 3(4).

on the basis of exercise of "employment, profession or duties", and also on the ground that the proposed acquisition is in the interest of the company. Both these formulations are contained in some of the three jurisdictions examined herein.

(1) Legitimacy of Disclosures

The legal framework in the UK grants legitimacy for disclosures made by a person in furtherance of employment, profession or duties.[99] Disclosures are treated as falling within the purview of this provision if they are made in relation to a transaction such as a takeover or private placement, and that the recipients are bound by strict confidentiality obligations, all as discussed earlier in this paper. Although the legal regime imposes this requirement on the target and its management, the precise application of this condition could vary depending upon the facts and circumstances of each case. Ultimately, legitimacy would hinge on whether the disclosure made to a person in connection with a share acquisition was necessary for the appropriate purpose.

The ECJ had occasion to examine the scope of this legitimacy condition where it adopted a narrow approach.[100] Interpreting the provision strictly, it held that disclosure is "justified only if it is strictly necessary for the exercise of an employment, profession or duties and complies with the principle of proportionality".[101] Consequently, it found that there must be "a close link between that disclosure and the exercise of that employment, that profession or those duties in order to justify such disclosure".[102] This imposes an onerous obligation on the target's managers to ensure that the disclosure through due diligence is necessary considering the circumstances of the transaction. Moreover, it requires the target to take the necessary precaution by entering into robust confidentiality agreements with the acquirer or any other person who is likely to receive inside information in connection with the transaction.

While the above test relates to legitimacy for the disclosure, in certain cases the requirement could extend to justification for the company entering into the transaction in the first place, which imposes more obligations on the directors of the target.

(2) Interests of the Company

The duties governing the board of directors under company law would apply to share

---

[99] MAR 1, 1.4.5E. This approach will continue in the future in EU MAR, recital (35). See also, Niamh Moloney, *EU Securities and Financial Markets Regulation*, 3rd ed. (Oxford: Oxford University Press, 2014) at 727.

[100] *Grongaard & Bang*, ECLI:EU:C:2005:708 (reference from Denmark).

[101] *Grongaard & Bang*, ECLI:EU:C:2005:708 (reference from Denmark) at [34].

[102] *Grongaard & Bang*, ECLI:EU:C:2005:708 (reference from Denmark) at [31].

acquisitions generally, and to disclosures made under due diligence specifically. At common law, directors are required to act bona fide in the interest of the company. This duty has been invoked in transactions involving share acquisitions and takeovers.[103] In all of the three jurisdictions under examination, this duty has been codified to varying degrees. For example, in the UK, it is subsumed under the duty to promote the success of the company.[104] Similar codification has occurred in Singapore and India as well.[105] However, the insider trading regime in India has expressly extended this requirement to the disclosure of inside information as part of due diligence. Not only must the due diligence be justified, but the "board of directors of the company [must be] of informed opinion that the proposed transaction is in the best interests of the company".[106] In other words, both the transaction as well as the due diligence must be in the best interests of the company.

These requirements pose significant obligations on directors to ensure that if they are providing due diligence to a preferred acquirer, then the transaction is in the interests of the company. They cannot agree to terms that bind themselves so as to prevent the acceptance of another more attractive offer. Similarly, as generally required under takeover regulation, the target may be compelled to share information that it has disclosed to its preferred acquirer to any subsequent unwelcome acquirer as well. While it is beyond the scope of this paper to examine in detail the directors' duty to act in the best interests of the company, it is an important factor to be considered when the target's board considers a share acquisition transaction, and more so when the management decides to disclose inside information as part of the due diligence process.

VI. Treatment of Inside Information Upon Deal Failure

The discussion thus far proceeded on the basis that the share acquisition for which due diligence was conducted will be successful. However, quite often, transactions are either shelved or unduly delayed after completion of the due diligence. In that case, the treatment of inside information available with the acquirer through due diligence becomes important, as it effectively places an embargo on the acquirer from dealing in the target's shares. None of the three jurisdictions deal with this scenario with the required clarity. Hence, it would be left to practitioners and regulators to devise methods

---

[103] *Dawson International plc v Coats Paton plc*, [1990] BCLC 560; *John Crowther Group plc v Carpets International plc*, [1990] BCLC 460.

[104] Companies Act 2006, s. 172; David Kershaw, *Company Law in Context: Text and Materials*, 2nd ed. (Oxford: Oxford University Press, 2012) at 381.

[105] Companies Act (50, 2006 Rev. Ed. Sing.), s. 157; Companies Act, 2013, s. 166 (India).

[106] SEBI Regulations, regs. 3(3)(i), 3(3)(ii).

to ensure that the insider trading regime is not breached.[107]

One avenue for acquirers to be able to trade in the target's stock once the deal is aborted would be to require the target to issue a cleansing statement by which any inside information received by the acquirer is disclosed to the market. However, in such a scenario, it may not be in the interest of the target to make such a cleansing disclosure, which could result in a stalemate. This could come in the way of carrying out due diligence in share acquisitions.[108] Pending clarity from the regulators in these jurisdictions, parties and their advisors may cater for this situation through appropriate provisions in the confidentiality agreement.

Added to this ambiguity is the question of whether the fact that the acquisition does not proceed is itself inside information, which may have to be cleansed. If a proposed acquisition has already been announced, then the termination of the acquisition is inside information, and any trading while in possession of such information could put the acquirer in breach of insider trading regulation. In such a circumstance, a cleansing announcement would be the appropriate way to proceed. In transactions involving a takeover offer, this position is expressly recognised in the Takeover Code both in the UK and in Singapore, which stipulate that no trading shall take placed once an announced offer is terminated unless a cleansing announcement is made.[109] This rationale would apply equally to announced transactions that do not involve takeover offers.

Transactions that create greater sensitivity are those not announced publicly. For example, if the target engages in market-sounding and then decides to abort the transaction due to poor response, the question arises whether a cleansing announcement is required before the shareholders who were approached can begin trading. The answer to this depends upon various factors, including the reason behind the poor response and consequent withdrawal of the transaction. This issue came to the forefront due to FCA's observations in the notice against David Einhorn which stated that in case of market sounding a wall-crossed party may be able to trade again in the issuer's shares "in cases where a transaction does not proceed, when an announcement is made to the market stating that a transaction was contemplated, but did not proceed".[110] Such a blanket statement caused consternation among practitioners. Upon a clarification sought by the

---

[107] Aparna Ravi, "Insider Trading and the Risks of Due Diligence Access", IndiaCorpLaw Blog (22 January 2015), available at http://indiacorplaw.blogspot.co.uk/2015/01/insider-trading-and-risks-of-due.html.

[108] Reports indicate that this is an acute problem in share acquisitions in India. Jayashree P. Upadhyay, "Due-diligence disclosure stump potential acquirers", *Business Standard* (14 October 2015); Lalit Kumar, "A major omission in in insider trading rules", *The Hindu Business Line* (25 November 2015).

[109] The Takeover Code, n. 4 on rr. 4.1 & 4.2 (UK); The Singapore Code on Take-overs and Mergers, n. 1 on rr. 11.1 & 11.2.

[110] FSA Final Notice, *David Einhorn* (15 February 2012) at [3.11].

City of London Law Society,[111] the FSA stated that "in some circumstances, the fact that a previously proposed capital raising is no longer going ahead will not necessarily constitute inside information" and that the conclusion in each case will depend on the specific facts and circumstances.[112] Therefore, it is impossible to expect a bright-line test in such cases, and acquirers will have to exercise caution while trading on the basis of market-sounding if the proposed private placement has been terminated.

The termination or undue delay in share acquisition transactions continue to face ambiguities as far as the insider trading regime is concerned. Although matters are somewhat clear in relation to inside information obtained in due diligence (which are to be addressed through cleansing announcements), parties have to tread cautiously when previously unannounced deals are aborted or delayed.

VII. Conclusion

Due diligence is an important tool in share acquisitions transactions even in public listed companies that ensures the availability of necessary information with the acquirer so that it can decide whether to acquire shares in the target and, if so, on what terms. This will incentivise acquirers to carry out transactions that may be value-enhancing in nature for the target and its shareholders. But, such a due diligence causes information asymmetry, which needs to be addressed through the insider trading framework. Unless an appropriate balance is struck between these two competing goals, minority shareholders of the target will end up being caught between the rock and a hard place. The limited parity of information principle does provide for a theoretical justification for due diligence in listed companies, so long as a cleansing announcement is mandated coupled with an embargo on the acquirer trading in the target's shares prior to that.

Despite the sound theoretical foundation for the due diligence framework discussed above, several issues arise during the implementation of this principle in practice, as noted from the experience in the UK, Singapore and India. The ideal scenario requires a constellation of several factors to operate in tandem in order to maintain a desirable legal framework. All three jurisdictions have made substantial progress in their goal to attain parity of information. Among these, the UK has made the deepest inroads in addressing the practical considerations, culminating in the EU MAR's explicit and detailed prescriptions. Singapore and India have also expanded their frameworks, but to a lesser

[111] Letter from the City of London Law Society to FSA (2 March 2012), available at http://www.citysolicitors.org.uk/attachments/article/106/20120303-Letter-to-FSA-re-Einhorn-case.pdf.

[112] Letter from FSA to the City of London Law Society (23 March 2012), available at http://www.citysolicitors.org.uk/attachments/article/106/20120323-Response-from-FSA-re-cleansing-announcements.pdf.

degree. Although these two jurisdictions are not explicit in their treatment of due diligence information and market sounding mechanisms, they share the broad philosophy with the UK on structuring and enforcing an insider trading regime. Given the ever-growing incidence of cross-border acquisitions, greater harmonisation among jurisdictions will render greater clarity and certainty to acquirers and target managements that will ensure protection of minority shareholder interests and preservation of market integrity.

*****