FINANCIAL ORDERS UNDER SUBSECTIONS 23(1)(b) AND (c) OF THE SECURITIES (INSIDER DEALING) ORDINANCE — *INSIDER DEALING TRIBUNAL v SHEK MEI LING*

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Under section 23 of the Securities (Insider Dealing) Ordinance, the Insider Dealing Tribunal is given the power to sanction culpable insider dealers by making financial orders. Such financial orders are calculated with reference to 'profit gained' or 'loss avoided' as a result of the insider dealing. In Insider Dealing Tribunal v Shek Mei Ling, the Court of Final Appeal has provided authoritative guidance on how the 'profit gained' or 'loss avoided' is to be calculated.

Introduction

The purpose of subsections 23(1)(b) and (c) of the Securities (Insider Dealing) Ordinance[1] is to provide a non-criminal, but nevertheless very real, sanction against insider dealing.[2] Under subsection (1)(b), a person who has been identified as an insider dealer may be ordered by the Insider Dealing Tribunal to pay to the Government the amount of any profit gained or loss avoided by that person as a result of the insider dealing. Under subsection (1)(c) the Tribunal may also impose a penalty on that person in an amount not exceeding three times the amount of any profit gained or loss avoided as a result of the insider dealing.[3] While it is clear that the objective of s 23(1)(b) is to strip the

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1 Cap 395, Laws of Hong Kong. The relevant provisions read:

> 23(1) At the conclusion of an inquiry or as soon as is reasonably practicable thereafter, where a person has been identified in a determination under section 16(3) or in a written report prepared under section 22(1) as an insider dealer, the Tribunal may in respect of such person make any or all of the following orders — ... (b) an order that that person pay to the Government an amount not exceeding the amount of any profit gained or loss avoided by that person as a result of the insider dealing; (c) an order imposing on that person a penalty of an amount not exceeding three times the amount of any profit gained or loss avoided by any person as a result of the insider dealing.

2 See generally David Woods, 'Greed is Good, Hong Kong Style: A Review of the Current Insider Dealing Provisions' (1993) 2(2) Asia Pacific Law Review 70; Mark S Gaylord and Charles A Armitage, 'All in the Family: Corporate Structure, Business Culture and Insider Dealing in Hong Kong' (1993) 2(1) Asia Pacific Law Review 24; Katherine Lynch, 'Stock Market Crises and Insider Dealing in Hong Kong: The Need for Regulatory Reform' in Raymond Wacks (ed), *The New Legal Order in Hong Kong* (Hong Kong: Hong Kong University Press, 1999) pp 237-288; Paul Phenix, 'Defining Insider Dealing', May 1990 New Gazette 57; and Philip Smart, Katherine Lynch & Anna Tam, *Hong Kong Company Law: Cases, Materials & Comments* (Singapore: Butterworths Asia, 1997) pp 278-312.

3 In addition to these two orders, another sanction provided under the ordinance is an order, pursuant to s 23(1)(a) disqualifying a person from acting as a director or being concerned in the management of a listed company or any other specified company for up to five years.

insider dealer of his 'ill-gotten gains',[4] and the purpose of s 23(1)(c) is to impose a penalty and plainly has a significant deterrent element, how the 'profit gained' or 'loss avoided' is calculated is less certain. The Court of Final Appeal has recently given an important ruling on this issue.

Insider Dealing Tribunal v Shek Mei Ling

The facts of *Insider Dealing Tribunal v Shek Mei Ling*[5] were briefly as follows. The respondent became aware, in approximately May 1993, that her employer, Ng Kwong Fung, was acting for the Beijing Municipal Treasury Department in identifying a company in Hong Kong which was suitable for acquisition. In this context, she learnt that Hong Kong Worsted Mills Ltd ('Worsted') was being considered. Using borrowed money, the respondent bought 100,000 shares in Worsted at an average cost of $4.08 per share. On 31 May 1993, Worsted announced that an approach had been made by an independent third party (whose identity was not disclosed) to its majority shareholder to acquire a controlling interest in Worsted. On 3 and 4 June 1993, the respondent sold all her shares at an average price of $6.40 per share. However, on 17 June 1993, a further public announcement was made about the acquisition: the majority shareholder had agreed to sell its shares in Worsted to a state-owned company (which was an investment vehicle of the Beijing municipal government) at the price of net asset value plus a premium of $100 million. At this point dealings in the shares of Worsted were suspended. When trading of Worsted shares resumed on 22 June 1993, the shares closed at $15.10. Between 22 and 30 June 1993, the average price of Worsted shares was $16.80. In other words, the respondent had sold her shares too soon. If she had held onto them until after the market had absorbed all the information about the acquisition, she would have made a much higher profit.

After an inquiry, the Insider Dealing Tribunal found the respondent liable for culpable insider dealing. In determining the amount payable under both subsections 23(1)(b) and (c), it was necessary to decide the basis on which the 'profit gained' by the insider was to be calculated. The critical question for the Tribunal was whether the 'profit gained' should be calculated on the basis of the difference between the purchase price of the shares and the actual net sale price (no guidance is given by the Ordinance as to the manner of calculation). The view of the Tribunal was that the same method of calculation should be adopted in every case, regardless of whether the shares had been disposed of or not, regardless of the timing of the disposition of the shares, and regardless of the price actually received at the time of sale. Therefore, to calculate the 'profit gained' by the respondent, one should subtract the price paid for the shares from

4 Note 5 below, per Lord Nicholls of Birkenhead (at 883).
5 [1999] 1 HKLRD 879.

its value a short time after the relevant information became public. In other words, the Tribunal thought that the calculation of the 'profit gained' by the respondent should be based upon a 'notional' rather than an actual assessment.[6] The Insider Dealing Tribunal, therefore, held[7] that the profit gained by the respondent was not the profit she actually realized ($231,745) but was $1,262,643: this latter figure was calculated on the basis that she notionally sold her shares at $16.80 (taking into account the sale expenses). The Tribunal then made an order for payment of $600,000 under s 23(1)(b) and $1,200,000 under s 23(1)(c) against the respondent.[8]

The respondent's appeal to the Court of Appeal was allowed.[9] The Court of Appeal rejected the approach of the Tribunal and held that in calculating the 'profit gained' by the respondent, the 'notional profit' of $1,262,643 could not be attributed to her. The Court of Appeal considered the approach of the US Court of Appeals for the First Circuit in *SEC v MacDonald*,[10] namely that the appropriate point in time for calculating the insider's full gain was a reasonable time after the confidential price-sensitive information has become public. However, in the case of the respondent (the first appellant before the Court of Appeal), as she had sold her shares before the confidential price-sensitive information had fully become public, the test in *SEC v MacDonald* was

6 See [1998] 4 HKC 37 (at 43-44) for a discussion in the Court of Appeal of the Tribunal's approach.

7 See Report of the Insider Dealing Tribunal of Hong Kong on Whether Insider Dealing Took Place in Relation to the Listed Securities of Hong Kong Worsted Mills Limited [now renamed as Beijing Development (H.K.) Limited] between May 6th and June 16th 1993 (inclusive) and on Other Related Questions (Hong Kong: Printing Department, 1998). The Insider Dealing Tribunal also identified some others (besides the respondent) as insider dealers after the inquiry. They were Tai Lai Wo, Sinyo Wahid Winata Tan, Cheng Chun Ling and Dominic Leung Koon-Hong. Tai Lai Wo had business dealings with Ng Kwong Fung, who was the employer of the respondent. Tai was aware quite independently of the respondent that Ng and a Chinese party were looking for a Hong Kong company to take over. However, he was unaware of the identity of the target company until he was provided with the name of Worsted on 11 May 1993 by the respondent. He then purchased shares in Worsted. Tan was an Indonesian citizen doing business with Ng. He came to Hong Kong in May 1993 and was given the information about Worsted by the respondent shortly after his arrival. He then purchased shares in Worsted. Cheng was a Taiwanese jade and jewelry trader with whom both the respondent and Ng had previously done business. The respondent gave him the information about Worsted and he then bought shares in Worsted. Dominic Leung Koon-Hong was a qualified chartered surveyor and a director of a large property company in Hong Kong. The Tribunal identified him as an insider dealer, his purchases of shares in Worsted between 25 May and 28 May 1993 having been in breach of s 9 (1)(f) of the Securities (Insider Dealing) Ordinance. He received information relating to the contemplated take-over of Worsted after attending a meeting on 22 May 1993 with Ng Kwong-fung, some representatives of the major shareholder of Worsted and also some others involved in the contemplated take-over of Worsted.

8 The Tribunal is not bound to impose the maximum amount payable pursuant to s 23(1)(b) and (c) on the culpable insider dealer, but rather is empowered by the provisions to order the payment of a lesser amount.

9 [1998] 4 HKC 37. The appeals of the other three appellants, Tai Lai Wo, Sinyo Wahid Winata Tan and Cheng Chun Ling were dismissed. The Court of Appeal did not find that the Insider Dealing Tribunal had made an error of principle or law or that the financial orders were in totality manifestly excessive. The financial orders imposed on the other three appellants were in the region of 20 to 25 percent of the possible maximum that the Tribunal was empowered to impose under s 23.

10 725 F2d 9 (1st Cir 1984). The court in *SEC v MacDonald* referred to s 21(d)(2)(C) of the 1934 Securities Exchange Act (United States) which gives a statutory definition of the term 'profit gained' for the purposes of calculating the civil penalties which may be imposed by the US courts on insider dealers; see discussion below.

not applicable.[11] Instead, the Court of Appeal held that the correct calculation of the 'profit gained' by the respondent should be the profit that the respondent actually realized, which was $231,745. The Court therefore ordered that the amount payable under s 23(1)(b) and (c) should be $231,745 and $150,000 respectively. The Tribunal thereafter appealed to the Court of Final Appeal. The Court of Final Appeal was unanimous in dismissing the appeal. The only judgment was given by Lord Nicholls of Birkenhead NPJ, the other judges merely expressing their agreement with Lord Nicholls.

Calculation of the amount of 'profit gained'

No doubt, the most common insider trading situation is where an insider acquires confidential price-sensitive information, buys shares in anticipation of a subsequent rise in the market price of the shares, and then sells the shares at a handsome profit, after the price has risen upon the information becoming public. In this situation, the amount of the 'profit gained by [the insider] as a result of the insider dealing' is simply the difference between the purchase price and sale price of the shares.[12] Thus, where the insider dealing has consisted of a purchase made on the basis of confidential price-sensitive information, the general rule is that the 'profit gained' should normally be calculated by reference to the actual difference between (i) the cost of purchase and (ii) the net sale price of the shares realized by the insider dealer.[13] This is relatively unproblematic.

Equally unproblematic is where the insider, having bought the shares in anticipation of a price rise, chooses not to sell the shares (and realize the profit) when the confidential price-sensitive information becomes public, but instead retains the shares for a longer period of time. In such circumstances, the 'profit gained' by the insider dealer is measured by reference to the market value of the shares at the date when the information has been made public and the market has had reasonable opportunity to digest that information.[14] This must inevitably be a notional figure — since the insider dealer did not sell the shares at that date. As Lord Nicholls noted:

11 See note 9 above, pp 47-48, 53-55.
12 Note 5 above, p 883.
13 Ibid, p 884.
14 See Report of the Insider Dealing Tribunal of Hong Kong on Whether Insider Dealing Took Place in Relation to the Listed Securities of Success Holdings Ltd between 15 May 1992 and 12 June 1992 (Hong Kong: Printing Department, 1994). The Tribunal in the Success Holdings Ltd inquiry adopted the approach of the US Court of Appeals for the First Circuit in *SEC v MacDonald* (see note 10 above) that the appropriate point in time for calculating the insider's full gain was a reasonable time after the confidential price-sensitive information has become public. The Court of Appeal in *Insider Dealing Tribunal v Shek Mei Ling* (see note 9 above) considered *SEC v MacDonald*. However, as the respondent (the first appellant before the Court of Appeal) had sold her shares before the confidential price-sensitive information had fully become public, the test in *SEC v MacDonald* was held not to be applicable to the respondent.

> Subsequent changes in market prices are irrelevant for the purpose of a s 23 calculation. They are irrelevant, because such changes are not to be regarded as flowing from the original improper purchase of shares. Rather they flowed from the insider dealer's decision to retain the shares at a time when the effect of the misuse of the confidential information had become spent and the insider was on an equal footing with every other investor.[15]

Accordingly, where the effect of the misuse of the confidential price-sensitive information had become spent, any (further) profit made as a result of shrewd financial judgment on the part of the insider dealer would not be regarded as flowing from the improper transaction.[16]

What is more difficult is where the insider sells his shares *prematurely*, as in the case of the respondent. The Court of Final Appeal held that in such a case, the calculation of the 'profit gained' would be made on an actual net basis. The calculation would be dependent on the actual share price at the time of the disposal by the insider, rather than any notional figure.[17] This was because the transaction in the form of the improper purchase ended at the point when the respondent sold her shares. Lord Nicholls referred to that point in time as the 'cut-off date'.[18] Lord Nicholls also pointed out that if the legislature had intended that the amount of profit was to be fixed once and for all at the time of the improper purchase, the words used in s 23 would have been different, as in the abortive s 140 of the Securities Ordinance 1974.[19] Accordingly, the result is that the 'ill-gotten gains'[20] obtained by a loutish insider dealer — lacking the acumen to make full use of the information — will be less than that of a shrewd insider dealer who is able to take full advantage of the change in the market price of the shares in response to the information.

More interestingly, it would also follow that the maximum amount of the penalty which could potentially be imposed on the loutish and the shrewd insider dealer, pursuant to a s 23(1)(c) financial order, could vary quite

[15] Note 5 above, p 884.

[16] The Insider Dealing Tribunal in the Success Holdings Ltd inquiry noted that '... once inside information ... has percolated to and been absorbed by those who would normally deal in the securities of the corporation concerned, to a stage where the market's settled reaction to the information can be gauged, the benefit of the insider's unfair advantage crystallises, and what happens to the value of the securities beyond that stage is attributable to other factors.' See Insider Dealing Tribunal Report, note 14 above, pp 88-89.

[17] Note 5 above, pp 883-886.

[18] Ibid, p 885.

[19] Section 140(5) of the Securities Ordinance (Ordinance No 12 of 1974) provided that:

> Where a loss or profit ... is incurred by reason of an advantage gained from a dealing in securities, the amount of the loss or profit is the difference between —
> (a) the price at which the dealing was effected; and
> (b) the price at which, in the opinion of the court before which it is sought to recover the amount of the loss or profit, the dealing would have been effected at the time when it was effected if the specific information used to gain that advantage had been generally known at the time.

No commencement notice was ever made in respect of the provision and it was repealed in 1978.

significantly. Nevertheless, the practical significance of this point is diminished by the fact that the Tribunal is not bound to impose an order for the maximum amount payable under s 23(1)(c) but can exercise its discretion to take into account individual circumstances and mitigating factors to impose a lesser amount. In *Insider Dealing Tribunal v Shek Mei Ling*, the amount of the penalties imposed by the Insider Dealing Tribunal on the other culpable insider dealers, Tai Lai Wo, Sinyo Wahid Winata Tan and Cheng Chun Ling pursuant to s 23(1)(c) was actually less than the amount ordered to be paid pursuant to s 23(1)(b).[21] As for the respondent, the penalty imposed by the Tribunal pursuant to s 23(1)(c) was $1,200,000 (twice the amount ordered to be paid pursuant to s 23(1)(b)).[22] This penalty was subsequently reduced by the Court of Appeal to $150,000[23] and upheld by the Court of Final Appeal.

The Hong Kong Court of Appeal has requested[24] that the Government consider amending s 23 to provide concrete statutory guidelines for the assessment of the amount payable pursuant to a financial order under s 23 rather than relying on the discretionary powers of the Insider Dealing Tribunal.[25] In the United States, a statutory definition is given for the term 'profit gained'. Section 21(A)(f) of the Securities Exchange Act provides that 'profit gained' is 'the difference between the purchase ... price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the non public information.'[26] Nevertheless, in the opinion of Lord Nicholls,[27] since s 23 'stands alone without the assistance, or limitations, of a legislative definition'[28], the approach in the Securities Exchange Act did not assist materially in the interpretation of s 23(1)(b) and (c).

Calculation of the amount of 'loss avoided'

Lord Nicholls also made some interesting observations concerning the method of calculation of the amount payable under a s 23 financial order where the

20 Note 5 above, p 883.
21 See note 7 above, pp 102-103.
22 Ibid, p 102.
23 Note 9 above, p 55.
24 Ibid, p 50 (per Nazareth VP).
25 See Katherine Lynch (note 2 above), p 283.
26 Section 21(A)(a)(2) of the Securities Exchange Act (United States) empowers the US Securities and Exchange Commission to bring civil actions for disgorgement of profit gained (or loss avoided) and also for the imposition of civil penalties not exceeding three times the profit gained (or loss avoided) as a result of the unlawful purchase or sale which constitutes the insider dealing. Also, the US Department of Justice can bring criminal proceedings against any person violating US insider trading laws, see s 32 of the Securities Exchange Act (United States).
27 Lord Nicholls in his opinion referred to s 21(d)(2)(C) which was an earlier but in substance identical version of the current s 21A(f).
28 Note 5 above, p 886.

insider dealer has not made a profit but has avoided a loss. The first point was that the calculation of a 'loss avoided' involves a notional, rather than actual, calculation because '*ex hypothesi* the loss was not actually sustained by the insider dealer: the loss was avoided.'[29] The difference in approach to the calculation for situations where the insider used the confidential price-sensitive information to gain a profit or to avoid a loss is considered to be one of 'necessity'.[30] As explained by Lord Nicholls:[31]

> ... in the case of a dealing in shares, calculation of the amount of loss avoided will typically involve comparison of two elements, one actual (the shares were sold), and the other notional (what would have happened if the shares had been retained). The actual element in the calculation will comprise the amount realized by the insider dealer from the shares sold before the market learned the bad news. The notional element will comprise the market value of the shares at a date which has to be identified as the appropriate date. Failing cogent evidence that, in any event, the shares would have been sold before the market announcement, the date will usually be the date by which the market learned and absorbed the information. This will usually be the appropriate date because it can normally be expected that, save for the misuse of the confidential information, the insider dealer would still have held his shares at that date and, hence, would have suffered loss accordingly.

In other words, in the case of a calculation of the loss avoided, one must compare (i) the actual price of the shares when sold and (ii) the price of the shares after the market has absorbed the impact of the unfavourable price-sensitive information. As the loss never materialized but was avoided, the loss avoided is a notional loss and not an actual loss.

Extraneous factors affecting share price

If the insider dealer buys shares at a time when the market is generally rising, a portion of his 'profit gained' may be attributed to the general bullish market sentiment rather than exclusively due to the favourable price-sensitive information related to the insider dealing. Indeed, the court recognized that in a normal market there will be fluctuations in share prices for a variety of reasons unrelated to the price-sensitive information possessed by the insider dealer in question. As Lord Nicholls observed:[32]

[29] Ibid, p 886.
[30] Ibid.
[31] Ibid.
[32] Ibid, p 884.

> Markets do not operate in a sterile vacuum. The difference between the purchase and sale prices is likely to be affected, for better or for worse, by many factors beside the disclosure of this information. ... The factors involved may be general, affecting share prices of most companies or most companies in the relevant sector of the market, or they may be peculiar to the particular company but unrelated to the price sensitive information. In one sense, any increase in the insider dealer's profit due to favourable extrinsic facts such as these might be said not to form part of the insider dealer's profit gained 'as a result of' the insider dealing.

Thus, it follows logically that the calculation of the amount of the 'profit gained' should be adjusted to reflect the extent to which the sale price was increased or decreased by other extraneous matters whether favourable or unfavourable. However, Lord Nicholls thought that as a general rule no adjustment, whether upwards or downwards, was necessary to reflect the influence of extraneous factors, though his Lordship did not '... exclude altogether the possibility that there might be exceptional circumstances when some allowance would be called for.'[33] Without much elaboration, Lord Nicholls expressed the view that he did 'not believe the Ordinance envisages that any such problematic exercise is to be undertaken for the purpose of s 23.'[34] He said that references to 'profit gained' are 'to be read, naturally and consistently with the purpose of financial orders, as references to profits arising from buying and selling in the market, without any allowance for the ordinary incidents affecting market prices.'[35]

Whilst Lord Nicholls refused categorically to rule out the possibility of the existence of such 'exceptional circumstances', he did not explain what those exceptional circumstances might be. A situation might arise where the insider dealing consisted of a purchase made on the basis of confidential price-sensitive information, but in addition there was another piece of confidential price-sensitive information (which the insider was not aware of) which was released to the public at the same time as the first-mentioned information. The second piece of information may be far more significant than the first in terms of its effect on the share price. Would this be an 'exceptional circumstance'? Where the issue is loss avoided, would a stock market crash amount to 'exceptional circumstances'? For example, an insider dealer anticipating a fall in the share price due to specific price-sensitive information may sell relevant shares to avoid the loss; but then, shortly before the unfavourable piece of information is announced to the public, the stock market crashes.

[33] Ibid.
[34] Ibid.
[35] Ibid.

Evidently, the circumstances outlined in these instances would have a serious impact on the share price and hence significant repercussions in relation to the calculation of the amounts payable under s 23 financial orders. The consequences could be especially harsh on an insider dealer in scenarios where calculations are made on a notional, rather than an actual basis — such as where the insider dealer sells shares to avoid a loss and the stock market crashes after the sale of his shares. If the maximum amount payable pursuant to s 23(1)(b) is imposed, the insider dealer would be forced to 'disgorge' a notional amount of 'loss avoided' which may be far more than the amount anticipated merely on the basis of the confidential price-sensitive information which he has improperly made use of.[36]

Nevertheless, it is submitted that these circumstances should not be treated as 'exceptional circumstances' so that adjustments or allowances would be made in the calculations for s 23(1)(b) and (c). It is necessary to bear in mind that, in an insider dealing transaction, the insider dealer is often abusing a position of trust and confidence. The insider dealer has deliberately bought or sold the shares at the particular point in time because he wanted to take improper advantage of confidential information. When participating in the market, even stock market crashes and other sudden drastic changes in share prices are occurrences and risks which everyone invariably has to accept; and therefore, in that sense, they are nothing out of the ordinary. Perhaps, more importantly, the Tribunal is not bound to impose an order for the maximum amount payable under the financial orders but has the discretion to take into account individual circumstances and mitigating factors to impose a lesser amount.

Conclusion

At the end of the day, it seems that the calculation of the amounts payable pursuant to a s 23 order may be a rather artificial exercise. It may be more accurate to describe the guidelines for the calculation as an attempt to give an estimate or approximation rather than a scientific or mathematical formula of the 'profit gained' or the 'loss avoided' as a result of the insider dealing. In determining the calculation of a s 23 financial order, one has to bear in mind that the purpose of s 23(1)(b) is to make sure that the insider is not to be allowed to retain his 'ill-gotten gains'.[37] Therefore, whether it is a situation of 'profit gained' or 'loss avoided', what one is really concerned with is determining the benefit obtained (whether in the form of profit gained or loss avoided) by the insider as a result of the insider dealing transaction.

[36] The maximum amount of penalty which could be imposed on the insider dealer pursuant to s 23(1)(c) would be three times the amount of the 'loss avoided'.

[37] Note 5 above, p 883.

Nevertheless, the ruling of the Court of Final Appeal in *Insider Dealing Tribunal v Shek Mei Ling* has provided some useful guidance to the Insider Dealing Tribunal on the calculation of s 23 financial orders. As discussed above, where the insider dealing consists of a purchase made on the basis of confidential price-sensitive information, the 'profit gained' should generally be calculated by reference to the difference between the cost of purchase and the net sale price of the shares. Both figures would be actual figures based on the evidence of the transactions made by the insider dealer. Whereas, if the insider dealer does not sell the shares but retains them for a period of time after the information becomes public, the amount of 'profit gained' by the insider dealer would be the difference between (i) the cost of purchase and (ii) the market value of the shares at the date when the information has been made public and the market has had a reasonable opportunity to digest the information. The figure in (i) is an actual figure but (ii) must be a notional figure — as there was no actual sale of the shares at that time. Where the insider sells his shares *prematurely*, as in the case of the respondent in *Insider Dealing Tribunal v Shek Mei Ling*, the calculation of the 'profit gained' would be made on an actual net basis, which is based on the actual share price at the time of the disposal by the insider. As for the calculation of the loss avoided by an insider dealer, one would compare (i) the actual price of the shares sold and (ii) the price of the shares after the market has absorbed the impact of the unfavourable price-sensitive information. The latter would be a notional figure as there was no actual sale of the shares at that time.