

I F L R

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The 2009 guide to

Litigation



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Kim & Chang

Private equity beware

Jin Yeong Chung and Sungjean Seo of Kim & Chang on the dangers of insider trading and market manipulation litigation

Global financial players started investing heavily in the Korean market after the Asian Financial Crisis of the late nineties. For many years, the primary legal considerations facing foreign investors seeking to exit from their investments were the limitations imposed by their contractual obligations, as there were no specific regulations or court precedents regarding their exit. Recently, however, the Korean Financial Supervisory Service (FSS) and the Public Prosecutors' Office have taken an increasingly aggressive attitude towards the investigation of large-volume trades of listed companies preceding a significant change in stock prices and there have been some important decisions involving insider trading and market manipulation in the context of foreign investors' exits. In one noteworthy case involving allegations of insider trading, the Supreme Court closely examined the facts and circumstances surrounding use of non-public information that was available to an outside director appointed by the investors. Although the defendants were found not guilty, the case suggests an increased interest on the part of government regulators in this area and has important implications for foreign investors.

Penalising insider trading

Under the Financial Investment Services and Capital Market Act of Korea (the FSCMA replaced the Securities and Exchange Law from February 4 2009), the insider trading regulation applies to insiders and those that provide tips using, or causing others to use, "material information, not available to the public" in connection with the trading of securities or other transactions.

Insiders under the FSCMA are very broadly defined to include: (i) the company concerned (including its affiliates) and its officers, employees, and agents who are informed of undisclosed material information in connection to their duties; (ii) major shareholders (including shareholders with a shareholding of 10% or more, or shareholders participating in the material management of the company) of the company concerned (including its affiliates) who are informed of undisclosed material information in the course of exercising their shareholder rights; (iii) a person who has the authority pursuant to laws and regulations regarding permission, approval, direction, supervision or other authorities with respect to the company

concerned who is informed of undisclosed material information in connection with exercising such authorities; (iv) a person who entered into or negotiated for a contract with the company concerned who is informed of undisclosed material information in connection with negotiation for, execution of or performance under such contract; and (v) an agent, business representative or other employee of a person who falls under any of items (ii) through (iv) who is informed of undisclosed material information in connection with their duties. The categories of insiders specified in the FSCMA are so broad as to include practically any person with access to material non-public information by virtue of their office or position.

Material non-public information is also defined broadly to include any information relating to (i) the business affairs of a listed company; (ii) the tender offer of shares of a listed company (in such a case, the tender offeror is not subject to the insider trading rule, if it transacts such shares for the purpose of tender offer); or (iii) a large scale purchase or sale of shares of a listed company (in such a case, either purchaser or seller is not subject to the insider trading rule, if it transacts such shares for the purpose of the large scale purchase or sale). Material inside information should be of such a nature as to be able to impose significant influence on the investment judgment of an investor. Second, material inside information should not yet have been disclosed to the public so as to be known to many persons, pursuant to the enforcement decree of the FSCMA. This provision lays down a basis for determining when non-public information may be considered to have become public information in the context of insider dealing regulations. In this respect, it should be noted that even if particular information is disclosed or reported to the

Korean Exchange, the Korea Securities Dealers Association, or another regulatory authority, it will usually take some time before the information becomes generally available to the public. Accordingly, non-public information will be regarded to have become public information only when it becomes available to investors in general.

Corporate application

When a corporation is involved as a defendant in an insider trading case, it is necessary to determine who should be deemed to have received material non-public information and have used it to trade securities. The definition of insiders under the FSCMA includes corporate entities, and when the corporate entity with the insider information and the corporate entity making investment decisions are different persons, it would be necessary to show that either (i) the corporate entity with the insider information caused the corporate entity making investment decisions to use the material non-public information, or (ii) the corporate entity making investment decisions received the material non-public information.

When a corporation is involved in an insider trading case, employees of the corporation that have a contractual relationship with the issuer are also regarded as insiders. In such case, the company would have civil liabilities under Article 175 of the FSCMA, or tort liabilities under the Civil Code. If a representative, employee, agent or other servant is found guilty of insider trading in relation to the business of the company and the company did not conduct reasonable efforts or supervision to prevent such insider trading, the company can also be held vicariously liable and be subject to criminal fines (in addition to penalising the employee, who may be subject to imprisonment) under Article 448 of the FSCMA. The Company may be subject to the following fines, in accordance with the amount of profits gained or losses avoided in connection with the insider trading case:

(i) If the profits/losses are less than KRW 500 million: a fine not exceeding five hundred million won; or

(ii) If the profits/losses are more than KRW 500 million but less than KRW 5 billion: a fine equal to or less than three times the profits gained or losses avoided.

“There have been some important decisions involving insider trading and market manipulation in the context of foreign investors' exits”

Author biographies



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Mr Chung is a partner and leads the cross-border litigation practice at Kim & Chang. For more than 19 years, Mr Chung has successfully represented various foreign and domestic clients in numerous international litigations and arbitrations. His advocacy of a financial institution before the Korean court in a dispute against the governmental deposit insurance corporation led to an award of about one trillion Korean Won, the largest award ever granted by the Korean court up to that point. Recently, Mr Chung successfully defended a US-based hedge fund from criminal

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The 2008Do6219 Case

This case involved foreign equity investors who invested in a publicly traded company in 2000. At the time of the investment, the foreign equity investors, investing through two foreign special-purpose corporations, entered into a shareholders' agreement with the controlling shareholders of the company who were Korean. The shareholders' agreement provided, among other things, that the foreign investors would have certain managerial rights with respect to the company, including the right to appoint at least one director to the board of the company when certain threshold stakes were met.

Around July 2003, as the results of the financial performance of the company for the first half of the year became available, the senior management of the company became aware that the company's financial situation was in dire straits due to an accumulation of losses and a liquidity crisis, to the extent that the company would face bankruptcy unless special measures were taken. Around this time, the senior management also became aware that despite a capital injection of some KRW 1 trillion during the first half of that

year, the company was already in need of additional capital. This information was passed on to the audit committee of the board of directors at a meeting held in mid-August 2003 and to the rest of the board at a regularly held meeting of the board of directors which took place in early September 2003. As a result, the directors became aware that a capital increase of several hundred billion won within the year was inevitable. Subsequently, this information was disclosed to the market in late October 2003, through the board's resolutions regarding capital increase.

Meanwhile, earlier in June 2003, the foreign investors had made the decision to sell-off their holdings in the company and started negotiating a discretionary trading arrangement with a securities broker in Korea in mid-September 2003. A contract for a discretionary trading account was set up with the broker in early October 2003. The investors subsequently sold-off their holdings in the company through trades executed from mid-October to late October 2003.

Throughout the relevant period, an executive director of the two foreign special

purpose corporations served as an outside director in the company pursuant to the terms of the shareholders agreement. This executive director attended both the meeting of the audit committee and the meeting of the board of directors. A subsequent investigation by the FSS of these trades and of the trades of some of the controlling shareholders was followed by criminal prosecution against two individuals allegedly acting as agents or employees of the controlling shareholders, the executive director who served as the outside director of the two foreign special-purpose vehicles, and the two special-purpose companies through which the foreign equity investors had made their investments, on a theory of vicarious liability.

The court of first instance found that the information regarding the company's need for a capital increase was "material non-public information" and found that this information was created around July or August 2003. The court also found that the defendants acquired the information when it was mentioned at the meetings of the audit committee and the board in mid-August and early September 2003, respectively, and that since they sold their shares (or shares held by their principals) before the disclosure of the information in late October 2003, they committed the crime of insider trading prohibited under Article 188-2 of the Securities and Exchange Law.

The Seoul High Court reversed the lower court's decision, finding the defendants of the insider trading case not guilty of the charges. In a very fact-intensive analysis, the Seoul High Court articulated the four specific elements that need to be found in an insider trading case: (i) whether the defendant is an insider (including quasi-insiders); (ii) whether any material non-public information was created and delivered; (iii) whether there was any use of the information in connection with the trading of securities; and (iv) whether there was any avoided losses or gained profits. Specifically, the court ruled that the timing of creation of material non-public information should be determined taking into account the significance and probability of the information. In considering various internal documents of the company, especially those related to the meeting of the board and other circumstances, the court held that it would be reasonable to conclude that the information in question was created only in mid-September 2003.

A key factor in favor of the foreign investors and employee was the court's finding that there was a lack of use of the information. The court found that it was difficult to conclude that the defendants sold the shares "using the information in question" given the manner and timing of the sale, as well as the use of discretionary sales agreement.

In addition, in contrast to the court of first instance that concluded that the amount of avoided losses was the difference between the

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actual sale price and the lowest market price after the disclosure, the high court held that it was difficult to conclude that the defendants avoided any loss since the stock price fell for two days after the public disclosure of the information but recovered within four days thereafter the price level that had been in place before the disclosure, and subsequently maintained the same for a week.

The Seoul High Court decision was upheld by the Supreme Court in November 2008. As in the lower court decision, a key factor in the Supreme Court’s analysis was the presence of the discretionary trading arrangement that precluded the alleged use of the non-public information. The Supreme Court also found that the controlling shareholders had an incentive not to supply the information regarding the deteriorating condition of the company to the foreign investors earlier than they had to, given the risk that such information would encourage the foreign investors to accelerate their exit plans. In addition, the Court noted that the internal documents of the company around the time where the information was created were in fact classified as confidential, with only a handful of the key internal senior management having access, and that the outside director appointed by the investors did not have access to these documents.

It is significant to note, however, that with respect to the creation of material non-public information, the Supreme Court held that such information is created before such information becomes “objectively clear and certain”. The Court stated that in a corporate entity, important information does not materialise overnight but rather, becomes “more concrete and specific through many stages”, and therefore, that material non-public information should not be deemed to have been created when such information is objectively clear and certain, but earlier.

What to do

Although the defendants were acquitted in the 2008Do6219 case, the decision has significant implications for foreign investors exiting their investments. FSS’s policy for aggressive investigation regarding insider trading and market manipulation is expected

to continue, if not be stepped up, especially in the economic downturn. Although there are no legal safe harbours as such, careful planning and consideration of possible risks is essential in this environment.

(i) Stop attending any board meetings

Investors thinking of selling their holdings may consider not attending board meetings or any other meetings and events that may lead them to be introduced to inside information on the company.

(ii) Wait for quarterly disclosure of financial information before trading

Since much of the potential inside information deals with the financial information of the invested company, investors should try to wait for the quarterly disclosure of its financials prior to executing their trade.

(iii) Set up discretionary transaction accounts

As suggested by the 2008Do6219 case, setting up discretionary trading arrangement with a broker/manager may be very helpful in rebutting allegations of insider trading. In this regard, a trade order may be placed with an independent third party broker or manager to transact shares of the invested company. Such trade order should be at the discretion of such a broker within certain parameters, which can include (i) a time element (e.g. sell within six months of this order); (ii) a price ceiling and/or floor; and (iii) a number ceiling and/or floor on shares, provided to the broker at the initiation of the trade order. Because the transaction is at the discretion of the broker, for the purposes of the insider trading rules, such transaction may face less scrutiny from Korean regulators. Notwithstanding the foregoing, if the discretion of the broker is limited (e.g. a trade order requiring the sale or purchase of securities within a short period of time), this approach will be less effective in fending off regulator scrutiny.

(iv) Set up Chinese walls

Although setting up barriers to information does not provide an automatic defence in insider trading cases, strict Chinese wall policies may present a strong defence and may

also serve as a mitigating factor when the court determines the fine to be imposed or when the financial supervisory authorities determine the level of sanction to be imposed.

In terms of actual standards, restricting the flow of information between the division with the investment decision-making authority and the division with the inside information in the ordinary course would be important and it would be advisable to prohibit any sharing of information between the two divisions. More specifically, there should be a policy restricting the employees of the two divisions meeting with each other or exchanging documents with each other. If any communication is necessary, it should be made through e-mails, with precautions observed, so as to leave documentary evidence that the communication was proper. In addition, only the employees who have the proper authority and needs should have access to the confidential information, and those who have access to such information must manage the same in accordance with the Chinese wall policy and other standards set by the company. For such purpose, the confidential information must be protected by adequate security measures, such as pass codes. Also, those employees having access to confidential information should be prohibited from using the information for third parties or for their own benefit.

It would also be advisable for the two divisions to be physically separated. For example, the company should not allow the employees of one division to transfer to the other division, and the IT and office of the two divisions should be physically separated. In addition, if the legal entities to which the two divisions belong are different, and such legal entities are located in different countries, it would strengthen the argument based on the Chinese wall. Also, meetings at which confidential information may be discussed should be held at a location where such confidential information could not be leaked to other employees of the company.

It would be also be advisable for the two divisions to have different supervisors, and the persons who receive reports and other information from one division should not concurrently supervise the business activities of the other division, and to document the Chinese wall policy. In addition, if there are internal audits or reviews of the actual functioning of the Chinese wall policy, the result of such audit and review would be helpful to show that the Chinese wall is in fact in place at the institution.

It would be helpful if the institution applies the Chinese wall policy using the standards that are equivalent to, or stricter than, those used in other countries that have well-developed insider trading regulations, as the Korean authorities would be interested in finding out what the institution is doing in such other countries in relation to the Chinese wall policy.



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