Belated Disclosure and Capital Market Confidence

Chung, Yoon-Mo*

Hanmi Pharmaceutical's belated disclosure regarding its technology transfer agreement exposed many issues that can hardly be addressed by investor protection tools under the Financial Investment Services and Capital Markets Act (FSCMA). Among the issues are the appropriateness of items subject to disclosure obligations, listed corporations' improper handling of disclosure, insufficient content of disclosure information, possibilities of insider trading, etc. To tackle those issues, this article explores possible supplementary measures, e.g., renewed criteria for material information, more readable and concrete disclosure, and enhanced disclosure capabilities of listed corporations.

Recently, Hanmi Pharmaceutical's belated disclosure of its technology transfer agreement rose controversy as it allegedly imposed damages on investors and dented Korea's capital market confidence. Although the company has been blamed for having disclosed material information after the market opening, the disclosure at issue is regarded as legally permissible unless this involved any unlawful use of undisclosed information prescribed in Korea's current disclosure regime. This is adding complexity to the already serious issue.

Korea's disclosure regime has been in operation under the FSCMA for the purpose of eliminating information asymmetry between investors and enabling fair securities transactions. It also prevents imperfect disclosure from giving rise to any unfair trade practices such as insider trading. Furthermore, listed corporations, the subject of disclosure, are obligated to provide sufficient information to help investors make informed investment decisions in return for capital raised from investors.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* Ph.D., Research Fellow, Financial Law Team, Tel: 82-2-3771-0622, E-mail: cym@kcmi.re.kr

Despite the existing investor protection measures, the recent Hanmi case exposed many issues the existing measures alone can hardly address, such as the appropriateness of mandatory disclosure items, listed corporations' improper handling of disclosure, insufficient content of disclosure information, possibilities of insider trading, etc. Hereupon in this article, I first overview this case as well as the problems coming into the limelight. Then, I review possible responses to address the issues, which will eventually help protect investors and regain capital market confidence.

Overview of Hanmi Pharmaceutical's belated disclosure

On September 30, 2016, Hanmi Pharmaceutical stocks fluctuated wildly after its positive and negative disclosures. After the company disclosed its establishment of a $0.91 billion technology transfer agreement with US pharmaceutical company Genentech, it subsequently released a piece of negative news that its $0.73 billion technology transfer agreement established with German company Boehringer Ingelheim in 2015 was terminated.

At 4:00 pm after the market close on September 29, Korea's flagship pharmaceutical company Hanmi Pharmaceutical initially released a disclosure that it entered into a technology transfer agreement with Genentech, which is worth of $0.91 billion including a $0.08 billion initial payment and $0.83 billion milestone payments.

Shortly after this at 7:07 pm on the same day, Hanmi Pharmaceutical received a notification from Boehringer Ingelheim about the termination of the $0.73 billion technology transfer agreement on which Hanmi Pharmaceutical and Boehringer Ingelheim had signed on July 28, 2015. It is known that Boehringer Ingelheim terminated the agreement due to the lack of product competitiveness and side effects discovered during clinical trials. However, instead of immediately disclosing the termination, Hanmi Pharmaceutical delayed the announcement until 9:29 am on September 30 after the next trading day had begun.

On that day, Hanmi Pharmaceutical shares initially climbed about 5.5% thanks to the good news released on the previous day. But after the negative news came out, they quickly plunged more than 18% from the previous close. As the shares did not stop falling further after that trading day, investors suffered sizable losses.

To make matters worse, an allegation was raised about possible leaks of undisclosed material

information, citing that short-selling of the stock reached a record-high level at 100,000 shares on September 30, and that the orders for 50,000 shares among them were made even before the negative disclosure came out.

Problems in the Hanmi case

Corporate disclosure should disseminate useful information to investors in an effective manner in order to help them make informed investment decisions. Desirably, corporate information necessary for investment decisions should be fully disclosed, and the content must be accurate. Not only positive, but also negative information must be disclosed, and any omission of material information is unacceptable. Also important is the timing of disclosure. Disclosing information in a timely manner allows investors to take time for a reasonable investment decision, and at the same time prevents any insider from misusing material information that may lead to unfair trade practices. Lastly, the content of disclosure should be written in plain language so that every investor can easily understand. Taking into account those elements, I look at the problems exposed by the Hanmi case.

First and foremost, it is worth examining whether the details on milestone payments prescribed in the technology transfer agreement were properly disclosed in concrete, easy-to-understand text. Although technology transfer agreements related to new drug development are often terminated, stock price swings triggered by the Hanmi case were especially extreme partly due to the lack of detailed information. By nature, milestone payments included in that kind of agreements are paid out only under the condition that each milestone in drug development from clinical development and approval to commercialization is reached.

Although the content of disclosure in the Hanmi case included the term “milestone payment”, it is never easy for ordinary investors to understand what it actually means. Furthermore, the content lacks important details, e.g., the exact amount of each milestone payment. As a result, excessive fluctuations occurred when the establishment and termination were disclosed.

Second, given that any material information that affects investment decisions must be disclosed without exception, it is important to consider whether a large-scale technology transfer agreement should be regarded as material information and thereby classified as information subject to disclosure obligations. According to the Korea Exchange (KRX) disclosure regulations, both technology transfer agreements at issue are classified as voluntary disclosure items, so

that listed corporations have full discretion in the decision of whether to publicly disclose the information or not.[1)]

Korea's current disclosure regulations require listed corporations to report any fact or decision that falls under material business matters to the KRX on the day or by the next day of the occurrence. At the end of 2015, disclosure regulations began to shift towards the negative list approach from the existing positive list system, mandating listed corporations to disclose any fact or decision with regard to business, sales, and production activities as well as financial structures that may affect the stock prices or investment decisions. However, the introduction, transfer, and alliance of technology are currently excluded from disclosure obligations and classified as voluntary disclosure items, giving listed corporations full power to determine whether to disclose the information or not.

In view of the disclosure regime's intention to address information asymmetry between investors and thus enable fair securities transactions, such an improper boundary of material information subject to disclosure obligations may dent overall capital market confidence. Therefore, more efforts are required to bolster the negative list approach and subject a wider range of information to disclosure obligations.

Third, what was missing in the Hanmi case was the company's determination for addressing information asymmetry. Because the technology transfer agreement falls under the information subject to voluntary disclosure, delaying the timing of disclosure to the next trading day is deemed legitimate under the KRX disclosure regulations. However, for eliminating the chance of unfair trading due to information asymmetry among investors, it would have been much better if the information was disclosed before trading hours.

If technology transfer agreements fall under undisclosed material information and thus are subject to insider trading regulation, the relevant information must be strictly managed to prevent any investors from using such information in an unfair manner. In this case, after being notified of the termination, Hanmi Pharmaceutical should activate its internal control system for managing the information in order to prevent any leak and abusive use for unfair trading. And in the case of any leak of such undisclosed material information, it should immediately disclose the fact according to the "disclosure or abstain" principle, so that any unfair trading triggered by information asymmetry would not undermine capital market confidence.

1) Refer to §7(1) and §28 of the KOSPI Market Disclosure Regulation, and §8(1) of the Enforcement Rules of the regulation.

If listed corporations are capable of fully managing undisclosed material information and rooting out any possibility of insider trading, then there is no problem to release the information during trading hours. However, insider information is always prone to leaks. To address the issue in an ex ante manner and minimize potential information asymmetry among investors, it would have been more desirable to disclose such information before trading started. The abrupt surge in short-selling on Hanmi Pharmaceutical, despite the company's positive news about a large-scale technology transfer agreement, has raised suspicion on information leaks and insider trading using that information.

Future actions

To protect investors and secure capital market confidence as intended by the FSCMA, it is necessary to establish a disclosure system providing corporate information to investors, and to devise a reasonable unfair trading regulation preventing any unfair market transactions. Based on the compatibility with international standards, I try to propose supplementary measures to address the problems exposed by the Hanmi case.

First, it is important to adjust the range of material information investors need for informed investment decisions. Establishing an agreement for the adoption, transfer, and alliance of technology is currently an item subject to voluntary disclosure, not mandatory disclosure, so that the issuer can decide whether to disclose the information or not.

However, the size of these agreements compared with Hanmi Pharmaceutical's KRW 1.31 trillion sales in 2015, and the abrupt fluctuations in Hanmi Pharmaceutical shares at the time when the company disclosed its establishment and termination of technology transfer agreements appear to provide a valid reason for classifying the agreement as material information subject to disclosure obligations. It is worth reviewing whether to classify the large-scale adoption, transfer, and alliance of technology into disclosure obligations or not by looking at the materiality criteria in precedent cases, for example, the probability-magnitude test in the TGS case,[2] and the substantial likelihood test in the TSC case.[3]

Second, the content of disclosure must be written in plain language. The milestone payment disclosed in the Hanmi case is a jargon ordinary investors can hardly understand. Furthermore,

2) SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.1968).

3) TSC Industries, Inc. v. Northway, Inc., 426 U.S.438 (1976).

it omitted important details. Without exact figures for the amount of each milestone payment, investors had no option but to guess the stock's value based on the aggregate milestone payments, which exacerbated stock volatility at the time of the establishment and termination of each agreement. In such a case, it is necessary to disclose not only the aggregate amount, but also the amount of each milestone payment. Also important is the fact that only less than 10% of newly developed drugs pass clinical trials and finally get approved for sales. A simple disclaimer warning that the company might not be able to receive all of milestone payments could have substantially curbed excessive price swings caused by the lack of information needed for investment decisions.

Third, listed corporations should bolster their disclosure capabilities. As a producer and supplier of information, they should disseminate material corporate information via disclosure in order to contribute to investor protection and sound market operations. Any listed corporation that taps into the capital markets for financing is obligated to address information asymmetry for creating an environment where investors can engage in securities transactions in a fair manner.

The process of disclosing and disseminating corporate information involves a wide array of stakeholders, and thus is prone to unfair trading such as insider trading. Hence, listed corporations must bolster their disclosure and internal compliance. Toward that end, they need to build a centralized system where a designated disclosure team collects and manages corporate information via compliance officers and internal controls. Also necessary are internal controls for handling material information, e.g., security policy, differentiated approaches depending on the content and confidentiality of information, information security awareness training for employees, a security system for the path of corporate information provision, etc.