

THE ONGOING BATTLE AGAINST INSIDER
TRADING: A COMPARISON OF CHINESE AND U.S.
LAW AND COMMENTS ON HOW CHINA SHOULD
IMPROVE ITS INSIDER TRADING LAW
ENFORCEMENT REGIME

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INTRODUCTION

Almost every country prohibits insider trading in order to protect its investors and to ensure fair and competitive security markets.¹ For the People's Republic of China ("China"), an effective and reliable financial market reasonably free of the stain of insider trading is essential for its successful integration into the global economy.² During its brief history with securities markets, China has made significant progress in setting up a legal framework to regulate those markets. Enforcement against securities fraud, particularly insider trading, however, is far from adequate. To rectify this problem, China must learn from the experiences of other countries, particularly that of the United States, in order to work out a suitable legal regime, not only to better protect its domestic investors (while attracting more foreign investors), but also to make its domestic businesses more competitive in a globalized economy, where cross-border exchange listings are increasingly common and where more Chinese business people are playing important roles in international companies. A recent U.S. Securities and Exchange Commission (SEC) settlement on insider trading involving a high-profile Chinese businessman presents a good illustration of how the insider trading laws of the two countries differ; specifically, in what respects China lags behind.

David Li, the chairman and CEO of the Bank of East Asia and a member of Hong Kong's Legislative Counsel, as well as its Executive Committee, was a director on the board of Dow Jones & Co. (DJ).³ Li, by virtue of his position on the board, learned that News Corporation (News Corp.) had made an offer to buy DJ for \$60 per share at a

1. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 264 (2007).

2. Charles Zhen Qu, *An Outsider's View on China's Insider Trading Law*, 10 PAC. RIM. L. & POL'Y J. 327, 327 (2001).

3. Martha Graybow & Karey Wutkowski, *Ex-Dow Jones Director Settles SEC Insider Trading Case*, REUTERS, Feb. 5, 2008, <http://www.reuters.com/article/idUSN0518183120080205>. Li also served on board of a number of public companies, including the holding company of Peninsular Hotel, HK's largest fixed line phone carrier PCCW, the publisher of South China Morning Post. Jin ji bo ke: Xianggang de jin rong jian guan you xiao ma? (China Economy Blog: Is Hong Kong's Financial Regulation Effective?), <http://blog.ce.cn/html/95/101095-74535.html> (Feb. 25, 2008, 13:02:02).

time when DJ shares were trading in the \$30 range.⁴ He told his close friend and business associate, Michael Leung, about the then unpublished news as soon as he obtained the information.⁵ After receiving the tip, Leung, through his daughter and son-in-law's Merrill Lynch account, bought \$15 million worth of DJ stock, which turned into an \$8.1 million profit when the News Corp. deal was announced.⁶ Leung's daughter and son-in-law also bought shares for themselves and made a \$40,000 profit.⁷ The SEC detected the abnormal transactions made by the couple and filed a civil charge against them within a week after the buy-out was announced on May 1, 2007.⁸ Meanwhile, the SEC also began investigating Li and Leung and subsequently filed charges against both.⁹ In February of 2008, the case was settled with Li agreeing to pay an \$8.1 million civil penalty, Leung agreeing to disgorge the \$8.1 million in profit, and to pay \$8.1 million in penalties, and his daughter and son-in-law being required to disgorge the \$40,000 of their profit and to pay a \$40,000 penalty.¹⁰

It is surprising that Li and Leung, both savvy businessmen, would allow themselves to become entangled in an insider trading case that was so easy for the SEC to detect. Leung's daughter and son-in-law were the most active individual purchasers of DJ stock in the weeks preceding the pertinent news announcement, and they sold their position shortly after the news announcement.¹¹ Naturally, it was not difficult for the SEC to connect the dots of the tipping chain, since Li was in the same airplane with Leung to Shanghai the day after he received the information about News Corp's bidding.¹² That Li and Leung were so casually involved in an insider trading scheme was probably the result of their perceptions of "insider trading," which had

4. Graybow & Wutkowski, *supra* note 3. New Corp. is one of the world's largest integrated media company and the company's Chairman, Chief Executive Officer and Founder is Rupert Murdoch. News Corporation - Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/News_Corporation (last visited Aug. 10, 2009).

5. Graybow & Wutkowski, *supra* note 3.

6. *Id.* See also China Economy Blog, *supra* note 3.

7. *Id.*

8. Greg Farrell & Matt Krantz, *SEC Regulator to Look into Unusual Dow Trades*, USA TODAY, May 9, 2007, http://www.usatoday.com/money/markets/2007-05-09-dow-jones-usat_N.htm.

9. *Id.*

10. Graybow & Wutkowski, *supra* note 3.

11. China Economy Blog, *supra* note 3.

12. *Id.*

been shaped by how such trading had been traditionally viewed and policed in China and Hong Kong.

China's stock market is less than twenty years old and its securities regulations regime, including that relating to insider trading, is relatively new.¹³ Because the United States securities regulatory scheme is deemed to be the world's most developed, China has embraced the U.S. model and has shaped its securities laws largely on U.S. laws.¹⁴ Although China's legal framework relating to insider trading is fairly comparable to those of the developed countries, it still contains many loopholes.¹⁵ What is more problematic, however, is the matter of China's seeming inability to effectively enforce its insider trading laws. From 1993 to 2008, there have been only 21 insider trading cases—administrative, criminal, and civil combined.¹⁶ This issue is of special importance to the country because weak and inefficient enforcement fails to serve the public interest in deterring insider trading and ensuring fair financial markets, nor does it improve public awareness of what constitutes insider information and, specifically, what constitutes a prohibited activity. Armed with more accurate information concerning the risks of insider trading, ordinary investors and corporate insiders should be more inclined to be cautious in dealing with “valuable information” and more likely to refrain from involving themselves in illegal insider trading schemes. For example, if Li had known that by tipping his friend, he would be violating insider trading laws, he probably would have refrained from jeopardizing his prominent positions in the business and political world.¹⁷

13. Hui Huang, *The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform*, 17 AUSTL. J. OF CORP. LAW 2 (2005), Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=753745.

14. Hui Huang, *supra* note 13, at 5. The United States directly assisted the drafting of China's securities law. *Id.*

15. See Hui Huang, *supra* note 13, at 5, 14.

16. Song Yixin, *Nei mu jiao yi fa lü ze ren ti xi yi jian li (The Legal Liability Regime of Insider Trading Has Been Established)*, CHINA SECURITIES J., Sept. 24, 2008, http://www.cs.com.cn/rx/03/200809/t20080924_1595249.htm. Among the 21 cases, there was no civil action and five were criminal prosecutions. *Id.* There were 13 administrative cases as of the date the article was posted, and an additional three cases in 2008 since then. *Id.*; See Zheng fu gong kai mu lu (Government Public Catalog), CSRC, <http://gkml.csrc.gov.cn/pub/zjhpublic/> (last visited Aug. 16, 2009).

17. Li resigned from the Executive Councils of Hong Kong after he settled the case with the SEC and was also under pressure to relinquish his position as a member of Legislative Councils. China Economy Blog, *supra* note 3; see also David Li -

From the perspective of the international financial markets, especially those in the United States, insider trading in China has become a matter of serious concern. This is because a growing number of Chinese companies are seeking listings on the U.S. stock exchanges. By 2008, there were more than 120 Chinese companies listed in the three major U.S. stock exchanges, and the number is still growing.¹⁸ Since these companies are now U.S. public companies, they, their “insiders,” and their shareholders have become subject to U.S. securities laws. It is, therefore, not only important for Chinese people involved in the financial and business world to understand the dynamics of insider trading, it is also critical for the relevant legal regime in China to be developed to a level comparable to that which exists in the United States so as to avoid confusion born of ignorance of law, and to promote fair and efficient financial markets both in China and elsewhere in the world.

The next section of this paper will examine the history of U.S. and Chinese securities legislation and will review and compare the current insider trading frameworks of the two countries. Finally, section two will examine the problems of the Chinese insider trading law regime, with a focus on the issue of enforcement, and will offer the argument that China should develop a multilevel enforcement regime, with an emphasis on relieving barriers to private actions as a near-term goal, and should introduce the U.S.-style class action as an essential long-term solution to this problem.

Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/David_Li (last visited Aug. 6, 2009).

18. *See* China Stocks (NYSE, NASDAQ and Amex) http://www.hometownstocks.com/all_stocks.php?hometown=china (last visit Aug. 7, 2009) (a list of Chinese company stocks listed on NYSE, NASDAQ and Amex, including information about their initial public offer dates (up until 2008) and their industrial sectors); *see also* The FINANCIAL - NYSE Euronext Continues to Lead U.S. IPO Market as NYSE IPOs Raise \$2.2 Bln in 1H 2009, [http://www.finchannel.com/Main_News/Markets/42098_NYSE_Euronext_Continues_to_Lead_U.S._IPO_Market_as_NYSE_IPOs_Raise_\\$2.2_Bln_in_1H_2009_/](http://www.finchannel.com/Main_News/Markets/42098_NYSE_Euronext_Continues_to_Lead_U.S._IPO_Market_as_NYSE_IPOs_Raise_$2.2_Bln_in_1H_2009_/) (last visit Aug. 31, 2009) (in the first half of 2009, there were two Chinese companies that went public on the NYSE).

1. *Background*

A. *Overview of the U.S. Insider Trading Laws*

The United States has been a pioneer in prohibiting insider trading.¹⁹ The primary source of the federal insider trading regulation is the Securities Exchange Act of 1934 (SEA),²⁰ which was enacted after the stock market crash of 1929.²¹ At that time, Congress also created the SEC to interpret and enforce the country's securities laws, and to protect investors.²² The most cited basis for prohibiting insider trading is Rule 10b-5,²³ an anti-fraud rule promulgated by the SEC pursuant to its administrative rulemaking authority under section 10(b) of the SEA.²⁴ Rule 10b-5, in pertinent part, makes it unlawful for "any person . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the sale or purchase of any security."²⁵

Using Rule 10b-5, U.S. courts have, over time, developed several underlying theories of insider trading liability.²⁶ The first theory is the "equal access theory," and the rule created based on this theory is known as the "disclose or abstain" rule.²⁷ According to this rule, any person who is in possession of material nonpublic insider information must disclose such information before trading, or if he cannot disclose the information, he must abstain from trading; otherwise, the person will violate Rule 10b-5.²⁸ The rationale of the rule is that all investors

19. Hui Huang, *supra* note 13, at 17.

20. 15 U.S.C. §§ 78a-78oo (2008).

21. Hui Huang, *supra* note 13, at 18.

22. How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation (Securities and Exchange Commission), <http://www.sec.gov/about/whatwedo.shtml#create> (last visited Aug. 7, 2009).

23. 17 C.F.R. § 240.10b-5 (2007).

24. 15 U.S.C. § 78j(b) (2001). § 10(b) of the SEA specifically prohibits "the use or employ[ment of] . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Securities Exchange Act, Section 10(b), 15 U.S.C. § 78j(b) (2000).

25. 17 C.F.R. § 240.10b-5.

26. Hui Huang, *supra* note 13, at 18.

27. *Id.* See also Stephen M. Bainbridge, The Iconic Insider Trading Cases, UCLA School of Law, Law & Economics Research Paper Series, Research Paper No. 08-05, 3 (2005), available at <http://ssrn.com/abstract=1097744>.

28. Hui Huang, *supra* note 13, at 19. See also Bainbridge, *supra* note 27, at 3.

in the securities marketplace should have “relatively equal access to material information,” and it is not only “unfair,” but also fraudulent if some people can take advantage of insider information in trading securities.²⁹ The equal access theory was later considered by the United States Supreme Court to be too broad, and was subsequently replaced by two fiduciary-duty-based theories: (1) the “classical theory” of insider trading liability and (2) the “misappropriation theory.”³⁰ These two theories serve as the current basis for U.S. insider trading regulations.³¹

The classical theory was first defined by the Supreme Court in *Chiarella v. United States*.³² The Court made it clear that a duty to disclose arises only when a fiduciary or other similar relationship of trust and confidence exists between the party with insider information and the party on the other side of the transaction.³³ Such insiders usually include employees, officers, directors, and agents of companies whose stocks are being traded.³⁴ In the DJ case, Li was a director of DJ; thus, he had a duty to disclose when DJ’s stocks were traded.

The classical theory defined by the Court in *Chiarella* significantly limited the insider trading prohibition and posed problems in finding liability in tipping cases.³⁵ Three years after *Chiarella*, the Supreme Court in *Dirk v. SEC*³⁶ solved the problem by making modifications to the classical theory by providing the manner in which a tippee’s liability can be found based on a fiduciary duty.³⁷ The Court determined that tippees’ liability is derived from the tippers/insiders who have breached their duty to disclose.³⁸ Tippees are liable for insider trading only when the tippers/insiders breach their fiduciary duty by receiving a direct or indirect “personal benefit” from tipping, and

29. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert denied*, 394 U.S. 976 (1969).

30. Hui Huang, *supra* note 13, at 18, 19. In *Chiarella v. United States*, the Supreme Court concluded that the equal access theory went too far from common law principles and was too broad, 445 U.S. 222 (1980).

31. Hui Huang, *supra* note 13, at 18.

32. Bainbridge, *supra* note 27, at 4.

33. Bainbridge, *supra* note 27, at 4-5 (citing *Chiarella*, 445 U.S. at 230).

34. *Id.* at 5.

35. *Id.* at 4-6.

36. 463 U.S. 646 (1983).

37. Hui Huang, *supra* note 13, at 21.

38. *Dirk*, 463 U.S. at 659-63.

when the tippees know or have reason to know of the breach.³⁹ Absent a “personal benefit” to tippers, no derivative duty will be passed on to tippees.⁴⁰ In the DJ case, Leung and his daughter and son-in-law were tippees. Their duty to disclose was derived from Li, the tipper/insider. Li’s personal benefit can certainly be implied from his personal and business relationship with Leung.

In addition to formulating tippee liability, the *Dirk* Court also defined the concept of “constructive insiders.”⁴¹ When underwriters, accountants, lawyers, or consultants enter into a special confidential relationship with a corporation and are given access to information solely for corporate purposes, they are treated as constructive or temporary insiders and owe a duty to disclose to the corporation and its shareholders.⁴² In this way, these intermediaries who have been entrusted with insider information could become tippers, even though they were actually tippees.⁴³

The misappropriation theory was adopted by the Supreme Court in *United States v. O’Hagan*.⁴⁴ Under this theory, if one uses the information of his principal to purchase or sell securities for his personal gain without disclosure, he defrauds his principal of the exclusive use of that information.⁴⁵ While the classical theory targets a corporate insider’s breach of duty to shareholders with whom the insider transacts, the misappropriation theory outlaws a person from trading on the basis of material, nonpublic information as a corporate outsider in breach of a duty owed not to a trading counterparty, but to the source of the information.⁴⁶ Hence, this is a “fraud on the source” theory.⁴⁷ In the DJ case, had Li been on the board of News Corp., instead of DJ, and used takeover information to trade DJ’s shares, he would have breached the fiduciary duty he owed to News Corp., the source of the information, not to DJ or its shareholders.

In response to the restrictions imposed by the Supreme Court on the scope of insider trading liability, the SEC promulgated Rule 14e-

39. *Id.*

40. *Id.*

41. Hui Huang, *supra* note 13, at 22.

42. *Dirk*, 463 U.S. at 655 n.14.

43. Hui Huang, *supra* note 13, at 22.

44. 512 U.S. 642 (1997).

45. Bainbridge, *supra* note 27, at 7-8.

46. *Id.*; Hui Huang, *supra* note 13, at 23.

47. Hui Huang, *supra* note 13, at 21.

3,⁴⁸ or the “tender offer rule,” in an effort to expand its power in fighting insider trading.⁴⁹ Rule 14e-3 effectively abrogates *Chiarella* and prohibits anyone from trading in securities in a tender offer situation if he possesses the material nonpublic information about the tender offer and knows or has reason to know that the information is from an insider.⁵⁰ There is no requirement that the trader or insider breach a fiduciary duty or a duty created by a confidential relationship.⁵¹

In addition, Section 16 of the SEA⁵² provides a rule restricting “short-swing trading” by insiders of public companies, including officers, directors, and shareholders holding more than 10% of the outstanding shares.⁵³ The short-swing rule imposes strict liability upon such insiders if they make profits within a six-month period of time by trading their companies’ stock, and does not require proof of actual use of insider information or a showing of any intent to profit from such information.⁵⁴

More recently, the U.S. Congress enacted several supplementary rules including the Insider Trading Sanctions Act of 1984⁵⁵ (ITSA), which authorizes the SEC to ask the courts to impose penalties on illegal traders and upon those who tip nonpublic information to third parties⁵⁶, and the Insider Trading and Securities Fraud Enforcement Act of 1988⁵⁷ (ITSFEA), which gives the SEC authorization to ask courts to impose a civil penalty of three times the profit from illegal insider trading.⁵⁸ In the DJ case, if Leung had not settled for \$8.1 million in penalties, he could have faced the possibility of a penalty three times that amount.

48. 17 C.F.R. § 240.14e-3 (1999).

49. Thomas C. Daniels et al., An Overview of Legal Risks for Distressed Claims Traders at 3 (2006), available at http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S3839.

50. Susan Lorde Martin, *Insider Trading and Rule 14e-3 after Chestman*, 29 AM. BUS. L.J. 665, 671 (1992).

51. Martin, *Supra* note 50, at 675.

52. 15 U.S.C. § 78p (2002).

53. *Morrison v. Madison Dearborn Capital Partners III L.P.*, 463 F.3d 312, 314 (3d Cir. 2006).

54. *Morrison*, 463 F.3d at 314.

55. 98 Stat. 1264 (1984) (codified in scattered sections of 15 U.S.C.).

56. Insider Trading Sanctions Act of 1984 (ITSA): Definition From Answer.com, <http://www.answers.com/topic/insider-trading-sanctions-act-of-1984-itsa> (last visited Aug. 8, 2009).

57. 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.).

58. Thomas, *supra* note 49, at 4.

B. *Chinese Insider Trading Law—The Securities Law and Its Loopholes*

In contrast to the long history of U.S. stock markets and the country's attendant securities regulatory scheme, China's stock exchanges are new, having been established as recently as the early 1990s.⁵⁹ China did not enact its first securities law until 1998 (which took effect in 1999), and after undertaking a major legislative overhaul in 2005, China implemented the current *Securities Law*⁶⁰ in 2006.⁶¹ The State Council of China established the China Securities Regulatory Commission (CSRC), a counterpart to the SEC, shortly after China's two stock markets were established.⁶² The CSRC, however, did not become a ministry rank unit exclusively responsible for securities regulation in China until 1998.⁶³

Although China's financial markets are less than twenty years old, the Chinese government has been determined to outlaw insider trading since the establishment of its first stock exchange.⁶⁴ In the early 1990s, the State Council and the CSRC released several Provisional Measures to regulate the securities companies and stock markets, all of which addressed the issue of insider trading.⁶⁵ In 1997, the *Criminal Law* of China was revised to include insider trading.⁶⁶ The

59. Bjorn Sorenson, *Is A Growing China A Threat to United States IPO Market Dominance? Comparative Securities Laws and Competition in the Market for Markets*, 4 BUS. L. BRIEF (AM. U.) 22, 25 (2008). The Shanghai Stock Exchange was established in December 1990 and the Shenzhen Stock Exchange was established in June 1991. *Id.*

60. Securities Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, amended Oct. 27, 2005, effective Jan. 1, 2006) (P.R.C.), available at <http://www.china.org.cn/english/government/207337.htm> ("*Securities Law*").

61. Han Shen, *A Comparative Study of Enforcement of Insider Trading Regulation between the U.S. and China* 5 (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=964548.

62. *Id.*; Sorenson, *supra* note 59, at 4.

63. Hui Huang, *supra* note 13, at 3.

64. *Id.* at 3-4.

65. *Id.* The term of "insider trading" was first seen in Provisional Measures for Regulating Securities Companies (1990). *Id.* at 3. In 1993, the State Council released the Provisional Regulations on the Administration of Stock Issuance and Trading (1993), which contained several provisions regarding insider trading. *Id.* Shortly afterwards in 1993, CSRC promulgated the Provisional Measures for the Prohibition of Securities Fraud (1993), which devoted a set of detailed provisions to insider trading. *Id.* at 4.

66. *Id.* at 4.

first *Securities Law* (1999) devoted five articles to insider trading,⁶⁷ and the new *Securities Law* (2006) clarifies some vague terms and also addresses several shortcomings with respect to administrative liabilities and fines.⁶⁸

China's *Securities Law* contains a provision⁶⁹ that generally prohibits any person with access to insider information from using such information to trade securities.⁷⁰ This broad prohibition, however, is restricted by a list of specific types of persons who are considered "insiders."⁷¹ According to this list, statutory insiders can be grouped into three categories.⁷² The first category includes traditional corporate insiders, such as officers, directors, high-level managers, as well as the company's holding corporation.⁷³ Lower-level employees are also considered insiders if they have obtained insider information in connection with their employment.⁷⁴ In addition, a shareholder with 5% or more of a public company's shares is considered an insider, and is

67. *Id.*

68. Han Shen, *supra* note 61, at 27.

69. *Securities Law*, art 73.

70. Han Shen, *supra* note 61, at 5.

71. *Id.* See also Hui Huang, *supra* note 13, at 6. According to Article 74, "insiders" include:

- (1) Directors, supervisors, and senior managers of an issuer;
- (2) Shareholders who hold no less than 5% of the shares in a company as well as the directors, supervisors, and senior managers thereof, or the actual controller of a company as well as the directors, supervisors, and senior managers thereof;
- (3) The holding company of an issuer as well as the directors, supervisors, and senior managers thereof;
- (4) The personnel who may take advantage of their posts in their company to obtain any insider information of the company concerning the issuance and transaction of its securities;
- (5) The functionary of the securities regulatory body, and other personnel who administer the issuance and transaction of securities pursuant to their statutory functions and duties;
- (6) The relevant personnel of recommendation institutions, securities companies engaging in underwriting, stock exchanges, securities registration and clearing institutions and securities trading service organizations; and
- (7) Any other person as prescribed by the securities regulatory authority under the State Council.

Securities Law, art. 74.

72. Hui Huang, *supra* note 13, at 7.

73. *Id.*

74. *Id.*

subject to reporting requirements and is prohibited from short-swing trading.⁷⁵ These obligations are similar to Section 16 of the SEA, except that the threshold of the U.S. regulation is higher, which requires a 10% holding of a stock.⁷⁶ The second category is the equivalent of the constructive or temporary insider under the U.S. law, which includes underwriters, accountants, lawyers, consultants, and clearing institutions.⁷⁷ The third category of persons covers governmental officials who exercise regulatory authority over securities trading.⁷⁸

Besides the above three primary categories of “insiders,” any person who illegally obtains insider information is also subject to the same duty as an insider.⁷⁹ Under U.S. law, however, there can only be a violation under such circumstances on the basis of the misappropriation theory,⁸⁰ or, in the case of a tender offer situation, Rule 14e-3.

Under the *Securities Law*, insiders may find themselves in violation of insider trading laws not only by trading stocks on the basis of insider information, but also by merely tipping or advising third parties to buy or sell the relevant securities.⁸¹ Whether any trading has actually occurred is not relevant to the liability of such insiders.⁸² These *Securities Law* prohibitions are broader than those existing under U.S. law. Under Rule 10b-5, a tipper may be liable for insider trading only if the tippee actually bought or sold securities using the tip, and if the tipper personally benefited from the tipping.⁸³ The enumeration of insiders under the *Securities Law*, however, does not include tippees, such as Leung, his daughter and son-in-law, and the statute does not prohibit tippees from trading on insider information or re-tipping.⁸⁴ In addition, close family members of an insider, such as a

75. *Id.*

76. *Supra* text accompanying note 53.

77. Hui Huang, *supra* note 13, at 7.

78. *Id.*

79. *Id.* Art. 76 of *Securities Law* states: “Any insider who has access to insider information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information, or advise any other person to purchase or sell such securities.” *Security Law*, art. 76.

80. Hui Huang, *supra* note 13, at 7.

81. *Id.* at 7-8.

82. *Id.*

83. *Id.* at 8. Any Rule 10b-5 violation must be “in connection with a purchase or sale of securities.” Securities Exchange Act, Section 10(b), 15 U.S.C. § 78j(b) (2000). See *supra* text accompanying note 39 (requirements of tippee liability).

84. Hui Huang, *supra* note 13, at 15; see also Zhen Qu, *supra* note 2, at 338.

spouse and children, are not included in the *Securities Law* as insiders either, and as a result this group of people who often have the convenience to legally obtain insider information are not subject to insider liabilities unless they obtain the information by employing illegal means.⁸⁵ Another group of people who can escape insider trading liabilities in China are corporate officers or directors who trade stocks after they step down from their official positions, even though the trading is made based on the information they obtained while they were on their posts.⁸⁶ These groups of people represent examples of the “loopholes” in China’s *Securities Law* in terms of the scope of the definition of “insider.”⁸⁷

Similarly, the *Securities Law* sweeps broadly in its definition of “insider information” and in its detailed itemization of the specific types of facts that are to be treated as “inside information.”⁸⁸ In sum-

85. Zhang Xiuquan & Huang Xin, *Wo guo zheng quan shi chang nei mu jiao yi de fa liu tou shi* (A Legal Analysis of Insider Trading on Security Market of Our Country), 17 J. HENAN ADMIN. INST. OF POLITICS & L. 24 (ISSUE 5) (2007), available at http://www2.zzu.edu.cn/lawc/Article_Show.asp?ArticleID=60.

86. *Id.*

87. Hui Huang, *supra* note 13, at 15.

88. *Id.* at 8. Insider information is defined as “the information that concerns the business or finance of a company or may have a major effect on the market price of the securities thereof and that hasn’t been publicized in securities trading.” *Securities Law*, art. 75. Information that is considered insider information includes:

- (1) The major events as prescribed in paragraph 2 of Article 67 of the present Law;
- (2) The plan of a company concerning any distribution of dividends or increase of capital;
- (3) Any major change in the company's equity structure;
- (4) Any major change in guaranty of the company's obligation;
- (5) Where the mortgaged, sold or discarded value of a major asset as involved in the business operation of the company exceeds 30 % of the said asset in a one-off manner;
- (6) Where any act as conducted by any director, supervisor or senior manager of the company may be rendered liabilities of major damage and compensation;
- (7) The relevant plan of a listed company regarding acquisition; and
- (8) Any other important information that has been recognized by the securities regulatory authority under the State Council as having a marked effect on the trading prices of securities.

Id. “Major events” include:

- (1) A major change in the business guidelines or business scope of the company;

mary, insider information includes not only internal information generated within the company, but also external market information, which is usually the government policies information.⁸⁹ The special treatment regarding “government policies information” in the Chinese insider trading law is arguably necessary because, in China, government policies change frequently, and such changes always have a significant effect on entire sectors of companies.⁹⁰ The listing of insider information, as it is defined in the *Securities Law*, is detailed and extensive, but, as noted, loopholes still exist. For example, the kinds of facts such as those reflected in *Texas Gulf Sulphur* (wherein the company discovered minerals in exploratory drilling) do not fall under any item listed as “insider information” in Articles 75 and 67 of the *Securities Law*.⁹¹

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- (2) A decision of the company on any major investment or major asset purchase;
 - (3) An important contract as concluded by the company, which may have an important effect on the assets, liabilities, rights, interests or business achievements of the company;
 - (4) Any incurrence of a major debt in the company or default on an overdue major debt;
 - (5) Any incurrence of a major deficit or a major loss in the company;
 - (6) A major change in the external conditions for the business operation of the company;
 - (7) A change concerning directors, no less than one-third of supervisors or managers of the company;
 - (8) A considerable change in the holdings of shareholders or actual controllers who each hold or control no less than 5% of the company's shares;
 - (9) A decision of the company on capital decrease, merger, division, dissolution, or application for bankruptcy;
 - (10) Any major litigation involving the company, or where the resolution of the general assembly of shareholders or the board of directors have been cancelled or announced invalid;
 - (11) Where the company is involved in any crime, which has been filed as a case as well as investigated into by the judicial organ or where any director, supervisor or senior manager of the company is subject to compulsory measures as rendered by the judicial organ; or
 - (12) Any other matter as prescribed by the securities regulatory authority under the State Council.

Id., art. 67.

89. Hui Huang, *supra* note 13, at 9-10.

90. *Id.* at 10.

91. See Zhen Qu, *supra* note 2, at 340-41.

2. Analysis

A. Different Approaches in Formulating Laws—Common Law vs. Civil Law

The general framework of China's insider trading laws, established with the assistance of the U.S. SEC,⁹² largely mirrors U.S. law, with a few notable differences. The existence of these differences and various loopholes is mainly due to the fact that China is a civil law country, while the United States is a common law country.⁹³ In the U.S., the United States Supreme Court maintains the ultimate authority to interpret congressional legislation and to determine its constitutionality.⁹⁴ All courts have the obligation to follow precedents and must look to common law principals in order to interpret statutes and to make laws.⁹⁵ For example, when the United States Supreme Court decided that the Court of Appeals for the Second Circuit, in *Texas Gulf Sulphur*, went too far by adopting the equal access theory in interpreting Section 10b of the SEA, it employed the common law fiduciary duty theory to limit liability in securities fraud cases.⁹⁶ The fiduciary-duty-based classical theory turned out to be overly restrictive, and the Supreme Court struggled to find a "duty" owed by a violator where the violator is a tippee, or is a person who had misappropriated insider information.⁹⁷ The Court resolved the respective cases by carving out both the "tippee liability" theory and the "misappropriation theory."⁹⁸ The rationales behind the Court's decisions have been criticized, and the misappropriation theory has been particularly cha-

92. Hui Huang, *supra* note 13, at 5.

93. See Chinese law - Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/Chinese_law (last visited Aug. 16, 2009). China has adopted a civil law system with influence from the common law system. *Id.* ("[i]n formulating laws, the PRC has been influenced by a number of sources including traditional Chinese views toward the rule of law, the PRC's socialist background, the German-based law of the Republic of China on Taiwan, and the English-based common law used in Hong Kong. The law of the United States has also been very influential particularly in the area of banking and securities law").

94. See Law of the United States - Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/Law_of_the_United_States (last visited Aug. 16, 2009).

95. *Id.*

96. Bainbridge, *supra* note 27, at 4.

97. *Id.* at 5, 7; Hui Huang, *supra* note 13, at 24.

98. *Supra* text accompanying notes 38, 46.

racterized by its critics as “a theory in search of a rationalization.”⁹⁹ In addition, there continues to be a debate over whether the Court should go back to the equal access theory.¹⁰⁰ The SEC has actually been pushing for a broader base of liability, and its Rule 14e-3 is essentially a regulation based on the equal access theory.¹⁰¹

There are also on-going debates over whether China should adopt either of the equal access theory or fiduciary-duty-based theories.¹⁰² These debates are purely academic, however, because, as mentioned, China is a civil law country and its lawmakers are not bound by any particular existing theory or precedent. In China, courts do not have the power to create precedent and there are no common law principles or theories to which courts must adhere in rationalizing or supporting their decisions.¹⁰³ The National People’s Congress (NPC), China’s legislative body, is at liberty to create law based on policy considerations and to borrow from the laws of other countries that it finds suitable to accommodate China’s particular situation. For example, if “tippees” should become subject to insider liability, the *Securities Law* might simply include them as insiders without considering what the underlying theory and rationale of the characterization might be. The *Securities Law* in its current form, as it relates to insider trading, is actually well developed, except for the obvious loopholes, and these could be addressed by new legislation.

99. Hui Huang, *supra* note 13, at 27 (citing H S Bloomemthall, *Securities Law Handbook*, West Group, 1998, p 1183; M P Kenny & T D Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139 (1995); J R Beeson, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077; D M Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*, 59 OHIO ST. L. J. 1223 (1998)). The majority opinion in *O’Hagan* written by Justice Ginsburg showed that the majority believed that misappropriators should be liable for insider trading in order to protect investors from an informational disadvantage. See Bainbridge, *supra* note 27, at 29 (citing *O’Hagan*, 521 U.S. at 654-59). The majority opinion, however, was incoherent in its attempt to find a misappropriators’ duty to disclose based on the *Chiarella/Dirk* framework. *Id.*

100. Hui Huang, *supra* note 13, at 37.

101. *Id.*

102. See *Id.* at 29-37; Han Shen, *supra* note 61, at 12-14.

103. Han Shen, *supra* note 61, at 5.

B. *China's Problem—Ineffective Enforcement*

The widespread insider trading problem in China¹⁰⁴ does not lie in the imperfectness of the *Securities Law* itself; rather, it is largely due to the defects of China's enforcement mechanisms and practices. There exist no satisfactory methods by which to deter prohibited activities. Specifically, the regulatory authority, namely, the CSRC, does not effectively execute its power to enforce the insider trading laws due to a variety of reasons. The consequent weak enforcement of the law has resulted in a general lack of awareness of insider trading laws in China. Even if Chinese investors knew that certain activities were illegal, the risk of being caught and penalized is so slim as to be almost negligible,¹⁰⁵ and the rewards can be so high that investors often clamor to access insider information that will enable them to "beat the market."¹⁰⁶ This difficult situation is exacerbated by the Chinese culture, specifically, China's traditional social values, which place heavy emphasis on family ties and "connections" with friends and associates.¹⁰⁷ It is difficult, if not impossible, for relatives or friends not to do favors for each other, e.g., to pass along "valuable" information.¹⁰⁸ Also, to a certain extent, insider relationships and insider tipping are viewed as a form of business development.¹⁰⁹ In some respects, people with insider information feel a moral obligation to "tip" relatives, friends, and business associates.¹¹⁰ This may have been the reason why David Li passed the News Corp. take-over in-

104. Studies have "strongly suggested that insider trading is widespread in China." Wallace Wen-Yeu Wang & Chen Jian-Lin, *Reforming China's Securities Civil Actions: Lessons from PSLRA Reform in the U.S. and Government-Sanctioned Non-Profit Enforcement in Taiwan*, 21 COLUM. J. ASIAN L. 115, 124 (2008) (citing Hui Huang, INTERNATIONAL SECURITIES MARKETS: INSIDER TRADING LAW IN CHINA 15 (2006)). "According to Global Competitiveness Report's insider trading index constructed by Harvard University and the World Economic Forum, China's index was one of the highest among stock markets." Han Shen, *supra* note 61, at 5-6 (citing Du, Julian & Shang-Jin Wei, *Does Insider Trading Raise Market Volatility?*, 114 THE ECON. J. 916 (2004)).

105. *See supra* note 16 (from 1993-2008, in fifteen years, there have been only 21 cases arising from insider trading, in which violators were punished).

106. *See* Zhang Xiuquan & Huang Xin, *supra* note 85.

107. *Id.*

108. *Id.*

109. Sorenson, *supra* note 59, at 26 (citing Hui Huang, *supra* note 104, at 69-70).

110. *Id.*

formation to Michael Leung, his long-term friend and business associate.

(1) *Inadequate Enforcement Mechanisms*

Compared to the U.S. standard of enforcement, the mechanisms for insider trading law enforcement in China are grossly inadequate and are in no way sufficient to the difficulty of the task. While the measures available in the United States to enforce securities laws include SEC actions (both administrative and civil), private actions, class actions, shareholder derivative actions, and criminal prosecutions, in China, enforcement is undertaken only at the discretion of the CSRC, and is almost exclusively administrative.¹¹¹

China's *Securities Law* provides over 30 administrative liability provisions, 18 criminal liability provisions, but only four civil provisions.¹¹² Although the code provides for criminal liability,¹¹³ no criminal prosecution was ever pursued until 2003, and there have been only five criminal prosecutions arising from insider trading activities in the

111. *Id.* at 25.

112. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 117 n.2.

113. The *Securities Law* states: "Where anyone violates the present Law and [commits] a crime, he shall be subject to criminal liabilities according to law." *Securities Law*, art. 231. Criminal penalties are set out in Article 180 of the *Criminal Law*:

A person knowing inside information of securities transaction or a person obtaining illegally inside information of securities transaction who, prior to the information concerning issue of securities, transaction of securities or other information of great impact on the price of other securities is made public, buys or sells the said securities or reveals the information, shall be sentenced to fixed-term imprisonment of not more than five years or criminal detention and concurrently or independently, to a fine of not less than one time and not more than five times of the illegal gains therefrom if the circumstance is serious and; if the circumstance is especially serious, to fixed-term imprisonment of not less than five years and not more than ten years and concurrently to a fine of not less than one time and not more than five times of the illegal gains.

Criminal Law, art. 180 (Adopted at the 2d Session of the 5th Nat'l People's Cong., July 1, 1979; revised at the 5th Session of the 8th Nat'l People's Cong., Mar. 14, 1997 and promulgated by Order No.83 of the President of the People's Republic of China, Mar. 14, 1997, effective Oct. 1, 1997) (P.R.C.), available at <http://www.lehmanlaw.com/resource-centre/laws-and-regulations/criminal-law/criminal-law-of-the-peoples-republic-of-china-1997-page3.html> ("Criminal Law").

entire twenty-year history of China's stock markets.¹¹⁴ The civil liability provisions in the *Securities Law* state only that there are "liabilities of compensation" for a violation of the insider trading law, but provide no details on how these liabilities should be quantified.¹¹⁵ As a result, civil liability arising from insider trading has been practically non-existent. To illustrate this point, note that the Supreme People's Court¹¹⁶ (SPC) issued a circular¹¹⁷ ("*First Circular*") in September 2001, instructing local people's courts not to accept any civil compensation claims arising from insider trading and other securities frauds, explaining that "the people's courts do not have necessary conditions to accept and [to] hear such cases due to current legislative and judicial limitations."¹¹⁸ Shortly thereafter, the SPC issued two additional circulars¹¹⁹—one allowed local courts to hear civil cases arising from misrepresentations¹²⁰ ("*Second Circular*") and the other laid down de-

114. Sorenson, *supra* note 59, at 25 (citing Hui Huang, *supra* note 104, at 33); *supra* note 16.

115. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 121 n.23. The only civil liability provision in the *Securities Law* provides simply that "where any insider trading incurs any loss to investors, the actor shall be subject to the liabilities of compensation according to law." *Securities Law*, art. 76.

116. China's court system consists of the Supreme People's Court and different levels of local people's courts. Court System of the People's Republic of China - Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/Court_system_of_the_People%27s_Republic_of_China (last visited Aug. 12, 2009). In addition to trying cases within its original jurisdiction and reviewing lower court's decisions, the SPC is empowered to "give judicial explanations of the specific utilization of laws in the judicial process that must be carried out nationwide." People's Republic of China Supreme People's Court, <http://en.chinacourt.org/public/detail.php?id=24> (last visited Aug. 12, 2009).

117. The Notice of the Supreme People's Court on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases (promulgated by the Sup. People's Ct., Sept. 21, 2001, effective Sept. 21, 2001) (P.R.C.) ("*First Circular*").

118. Sanzhu Zhu, *Civil Litigation Arising from False Statements on China's Securities Market*, 31 N.C. J. INT'L L. & COM. REG. 377, 380 (2005) (citing *First Circular*).

119. The Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from False Statement on the Securities Market (promulgated by the Sup. People's Ct., Jan. 15, 2002, effective Jan. 15, 2002) (P.R.C.) ("*Second Circular*"); Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market (promulgated by the Sup. People's Ct. Adjudication Comm., Dec. 26, 2002, effective Jan. 9, 2003) (P.R.C.) ("*Third Circular*").

120. Misrepresentation generally refers to bad disclosure, which is defined to include "outright false statements, misleading statements, and material omissions."

tailed procedural rules for such litigation (“*Third Circular*”).¹²¹ Unfortunately, the SPC’s restriction upon the acceptance of civil actions arising from insider trading has not yet been lifted.¹²²

(2) *Unsatisfactory Enforcement by the CSRC*

As the primary agency for insider trading law enforcement in China, the CSRC’s record is far from satisfactory. In the entire enforcement history of the agency (1993-2009), there have been only 19 cases arising from insider trading activities.¹²³ These cases consist of less than 1% of all the securities fraud cases brought by CSRC.¹²⁴ Compared to the statistics of SEC enforcement, this number is alarmingly low.¹²⁵ Numerous reasons have been advanced to explain the inefficiency of the CSRC’s enforcement activities against insider trading. First, China’s stock markets were established by the government as a way to raise capital for state-owned enterprises (SOEs), most of which were uncompetitive and deeply troubled.¹²⁶ The shares that were sold to private investors through initial public offerings (IPOs) usually constituted no more than one-third of a given company’s equity.¹²⁷ The other two-thirds were owned by the state or by the SOE itself, and they are non-tradable.¹²⁸ Consequently, most of the public companies that are listed in China’s stock exchanges remain SOEs.¹²⁹ This situation creates an inherent conflict of interest. The CSRC, as

Walter Hutchens, *Private Securities Litigation in China: Material Disclosure about China’s Legal System?*, 24 U. PA. J. INT’L ECON. L. 599, 629 (2003) (citing *Second Circular*, art. 17).

121. Sanzhu Zhu, *supra* note 118, at 381.

122. *Id.*

123. *See Supra* note 16; in 2009 as to date, there are have been three insider trading cases. *See* CSRC’s website: Zheng fu gong kai mu lu (Government Public Catalog), <http://gkml.csrc.gov.cn/pub/zjhpublish/> (last visited Aug. 16, 2009).

124. Han Shen, *supra* note 61, at 18.

125. SEC brought 46 insider trading cases in 2006, 60 in 2008, and insider trading cases generally consist of 7-9% of all security fraud cases bought by SEC. China Economy Blog, *supra* note 3; U.S. SECURITIES AND EXCHANGE COMM., 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 12, 32 (2008), available at <http://www.sec.gov/about/secpar2008.shtml> (“*SEC 2008 Report*”).

126. Han Shen, *supra* note 61, at 7.

127. Sonia M. L. Wong, *China’s Stock Market: a Marriage of Capitalism and Socialism*, 26 CATO JOURNAL 389, 392 (2006), available at <http://www.cato.org/pubs/journal/cj26n3/cj26n3-1.pdf>.

128. *Id.*

129. *Id.*

regulator, and the SOEs, as regulated concerns, are all state entities. The CSRC has a political duty to guard state assets and government interests; thus, naturally, it will always be hesitant to take action against an SOE, which action may negatively affect state shares and assets.¹³⁰ Also, officials of the CSRC and those of the SOEs are often connected in one way or another, making it doubly difficult for the CSRC to enforce the insider trading laws. This situation also exists between the CSRC and fund management and securities companies. Many of the executives and directors of fund and securities companies are former officials in the CSRC or of one of China's two stock exchanges.¹³¹ The complicated entanglement between regulator and "regulatee" makes it particularly difficult for the CSRC to enforce the insider trading laws and to impose penalties against violators.

Another reason that has been advanced to explain the CSRC's weak enforcement record is that the CSRC is simply not equipped with the resources and power necessary to effectively enforce the *Securities Law*.¹³² To illustrate the point: upon initiating a formal investigation, the SEC has the subpoena power to access a company's documents and relevant records as well as to question the insiders,¹³³ however, the CSRC does not have power to obtain a citizen's communication records or his IP addresses.¹³⁴ This is because China's Telecommunications Regulations, consistent with China's Constitution, protects the confidentiality of such information, except in criminal investigations or matters of national security.¹³⁵ While the U.S.

130. Han Shen, *supra* note 61, at 18-19.

131. Ye Tan, *Cha chu nei mu jiao yi you liang da nan ti* (There Are Two Difficult Issues in Investigating and Sanctioning Insider Trading), *available at* <http://www.lanshizi.com/expertpost.aspx?tid=1069>.

132. Han Shen, *supra* note 61, at 19-20.

133. *Id.* at 17.

134. CSRC Jilin Branch, *Wan shan fa lü gui zhi, ti gao nei mu jiao yi an jian cha ban cheng xiao* (Perfect the Legal Framework, Improve the Effectiveness of Insider Trading Cases Investigation and Sanction) (2008), *available at* <http://www.csrc.gov.cn/n575458/n870348/n1338384/11001571.html>.

135. *Id.* Although the amended *Securities Law* gives CSRC the authority to "referring and photocopying" communication records, this provision conflicts with the Telecommunications Regulations, and as a result, CSRC's requests in investigations are often rejected by the telecommunication authorities. *Id.*; see *Securities Law*, art. 180(4); see also Telecommunications Regulations, which states that "[n]o organization or individual may, for any reason whatsoever, inspect the content of telecommunications, except that public security authorities, the State security authority and the People's Procuratorate may do so . . . in response to the requirements of State

SEC may initiate both administrative and civil proceedings to sanction insider trading, the CSRC has only one weapon—the administrative proceeding.¹³⁶ In that connection, the CSRC’s power in administrative sanction actions is more limited than that of the SEC.¹³⁷ Again, to illustrate: the CSRC does not have the authority to remove officers and directors from their corporate positions, but can only suggest to the companies which they serve that such persons be removed from their positions.¹³⁸ In November 2007, China’s State Council established a special enforcement bureau under the CSRC (in addition to the agency’s existing enforcement bureau) to facilitate the investigation of significant security fraud cases, including insider trading cases.¹³⁹ This newly increased force of almost 600 enforcement officers, although a significant boost for the CSRC, nevertheless, accounts for only half the number of the enforcement staff of the SEC.¹⁴⁰

C. *Measures for Improvement*

(1) *Closing the Loopholes*

Considering the current situation regarding insider trading law enforcement in China, it seems obvious that a number of measures could be taken to refine and perfect relevant substantive laws and to improve the mechanisms of enforcement so that the Chinese government might more effectively battle the problem. As noted, loopholes in the definitions of “insiders” and “insider information” must be closed. In the U.S., courts have the power to adjust the scope of these definitions through case law. In China, this can only be accomplished through legislative action.¹⁴¹ The legislator, the NPC, or its standing commit-

security or the investigation of criminal offences.” art. 66 (promulgated by the State Council, Sept. 25, 2000, effective Sept. 25, 2000) (P.R.C.).

136. Han Shen, *supra* note 61, at 26.

137. *Id.*

138. *Id.*

139. Singtao Financial, <http://www.singtao.ca/financial/2008-02-04/1202141461d804552.html> (last visited Aug. 25, 2009).

140. FACTBOX: SEC enforcement numbers over past 7 years, REUTERS, Aug. 14, 2009, <http://www.reuters.com/article/topNews/idUSTRE57D4HG20090814>. In fiscal 2008, the SEC had 1148 enforcement staff, and in fiscal 2005, this number was as high as 1232. *Id.*

141. This is particularly true considering that the CSRC is reluctant to use its discretion as afforded by the *Securities Law*, which enables it to identify “insiders” and “insider information” that are not enumerated in the law. Zhen Qu, *supra* note 2, at

tee, should review these lists and should revise them frequently in order to close these loopholes and keep the law current with fast-changing financial markets. Legislative amendments, however, may take years to accomplish, and, thus, may not represent the most efficient way to address the immediate problem. As an interim method to address the loophole problem, the SPC should exercise its “explanatory power” and should issue judicial explanations on matters such as the scope of the definition of “insiders” and of “insider information,” or elucidate on any other vague term in the *Securities Law*.¹⁴² Judicial explanations can be undertaken in a timely manner and have the inherent authority of the judicial process, nationwide.¹⁴³ In those instances where the law is silent, such explanations may serve as a suitable basis for CSRC enforcement.

(2) *Strengthening CSRC Enforcement*

China’s government must take necessary measures to strengthen the CSRC’s enforcement powers. While more funding and more highly qualified personnel are essential to handle the growing number of cases, the more important issue is the perceived need to eliminate the entanglement between officials and enforcement staff of the CSRC on the one hand and officers and managers of corporations and investment funds on the other. Whether by appointing outsiders or by infusing new blood through “new hires,” the CSRC and its personnel must become detached from any interest group operating in China’s financial markets.¹⁴⁴ Considering the limitations of its own resources,

342. The lists of “insiders” and “insider information” defined in the *Securities Law* each includes a “catch-all” item to be defined by the CSRC. *See Securities Law*, arts. 74(7), 75(8) and 67(12); *supra* note 73 and 90. CSRC has seldom, if ever, used its discretionary power to identify additional insiders and insider information. Zhen Qu, *supra* note 2, at 342.

142. *See supra* note 116 (one of SPC’s responsibilities is to issue “judicial explanations”).

143. *Id.*

144. The recent experience in Hong Kong illustrates the point well. In July 2008, Hong Kong’s Securities and Futures Commission (SFC) secured its first ever criminal conviction for insider trading, and since then, there have already been 10 convictions, including SFC’s latest victory in its biggest insider trading case involving a former Morgan Stanley Executive Du Jun. Jonathan Cheng, *Ex-Banker Guilty of Insider Deals*, WALL ST. J., Sept. 11, 2009, at C2. The significant improvement of SFC’s enforcement against insider trading is largely because two veteran executives were hired from Australia to lead the SFC and its enforcement department, and the

the CSRC should also change its current approach of “top-down regulation” over the two stock exchanges, and should encourage the exchanges to adopt self-regulatory mechanisms.¹⁴⁵ The NYSE represents a reasonably successful model of such a self-regulating organization that also plays an important role in enforcement against insider trading.¹⁴⁶ China should benefit from the experience of NYSE and should develop rules concerning the self-regulation of China’s two stock exchanges. This would relieve some of the burden on the CSRC.

D. *The Fundamental Change—Promoting Private Actions*

There are still more steps that the Chinese government can take to improve the country’s insider trading law regime. In order to affect a fundamental change in this rather bleak picture, however, China must adopt and fully develop an effective private civil action mechanism and must clear all existing hurdles that any investor may face in bringing such actions.

(1) *The Importance of Civil Enforcement*

The advent of civil enforcement will be essential in the overall effort to combat insider trading in several ways, because private actions will impose greater financial penalties than would public enforcements.¹⁴⁷ In the United States, both public enforcement and private enforcement are vigorous, and according to U.S. research data, total public sanctions ran at \$1,864,409,277 (2000-2002 data).¹⁴⁸ This included SEC and state sanctions as well as disciplinary sanctions by stock exchanges.¹⁴⁹ During the same period, private monetary awards totaled \$2,027,959,333.¹⁵⁰ This included settlements, trial awards, as

new leaders “have the advantage of being outsiders in a city where many of the business and political elite are intricately connected.” Jonathan Cheng & Peter Stein, *Hong Kong Stock Cops: From Mocked to Feared? An LSE Veteran, Martin Wheatley, Goes after Big Names*, WALL ST. J., Aug. 28, 2009, at C1.

145. Chenxia Shi, *Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement*, 24 ARIZ. J. INT’L & COMP. L. 451, 488-90 (2007).

146. *Id.* at 489.

147. Coffee, Jr., *supra* note 1, at 267.

148. *Id.*

149. *Id.*

150. *Id.*

well as arbitration awards by stock exchanges.¹⁵¹ Arguably, the greater the potential financial penalty, the greater the deterrent effect.

Insider trading law enforcement usually has two objectives: compensation and deterrence.¹⁵² In China, deterrence is a particularly important goal. Insider trading is so widespread in China that, at best, only a fraction of cases are detected, and fewer pursued. In order to improve this situation and to accomplish the ultimate objective of protecting investors and in maintaining the integrity of financial markets, a more efficient approach would *not* be to attempt to pursue every wrongdoer *ex post facto*; rather, it would be to deter potential wrongdoers with the threat of significant pecuniary loss. If the risk of being detected is so high and the financial penalty is so significant that the rewards of engaging in insider trading are no longer attractive, “insiders” will likely think twice before taking steps that will lead to violations of the insider trading law. By allowing private actions, all investors involved in the relevant trading will become potential *de facto* enforcement agents. Such a force would represent a major addition to the CSRC’s enforcement capacity. (It is noteworthy that in the United States, private actions serve as important support to the SEC’s enforcement efforts and play a significant role in deterring insider trading.¹⁵³) The aggregate amount of compensation to a group of private plaintiffs could potentially be many times greater than that resulting from administrative sanctions. The prospect of a significant risk of liabilities and high “cost” should be sufficient to deter large numbers of potential wrongdoers from “crossing the line” and would be reason enough for insiders to decline questionable requests or expectations from family members, friends, or business associates.

The private action is important also because it is the only way that a defrauded investor can be compensated for his or her losses. Administrative sanctions belong to the state treasury. Criminal convictions merely punish the violators. For an ordinary investor, the only redress is to bring a civil suit and make a claim for compensation. If the law deprives him of the right to seek this kind of redress, the fairness of the law becomes questionable. Again, if investors are allowed to seek financial compensation for their losses, they might easily become motivated to detect the illegal activities of others and to identify

151. *Id.*

152. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 137.

153. Huang, *supra* note 13, at 32.

violators, and in so doing, assist the CSRC in detecting more insider trading violations.

Private enforcement is more efficient than public enforcement because private investors do not ordinarily experience the kinds of conflicts of interest that are endemic to the CSRC due to its dual responsibilities, i.e., guarding state property and protecting private investors. Moreover, a particular person's personal connection with a violator becomes a non-issue in private action because the number of potential plaintiffs is great.

(2) *First Steps Toward Private Actions*

In light of the potential importance of private enforcement, the SPC should lift the prohibition against private actions and should allow courts to accept civil cases arising from insider trading, particularly since courts have gained a significant level of experience in hearing securities fraud cases arising from misrepresentation during the past few years.¹⁵⁴ Although the SPC has yet to issue an official circular regarding this matter, some progress is being made. In 2008, the first ever (and so far the only) civil compensation case arising from insider trading was heard by an intermediate People's Court; this, after a Deputy Grand Justice of the SPC, during a judicial conference in 2007, called for courts to hear insider trading cases as well as market manipulation cases.¹⁵⁵ This particular private action case marks an important first step toward civil enforcement of insider trading laws in China.

This private action arose from an administrative sanction issued by the CSRC against Chen Jianliang, a former executive of Xinjiang Tianshan Cement Co. who had engaged in insider trading.¹⁵⁶ Chen used his knowledge regarding a pending corporate restructuring of Tianshan Co. to trade its stock between June 21 and June 29, 2004,

154. See *supra* text accompanying note 120.

155. Min shi suo pei neng you xiao e zhi zheng quan wei fa xing wei (Civil Compensations Can Effectively Deter the Illegal Activities in Securities), LAWTIME, available at <http://www.lawtime.cn/info/zhengquan/qtwf/20090423649.html> ("Civil Compensations").

156. Wang Guocheng, *Tianshan gu fen fu zong Chen Jianliang nei mu jiao yi fa 20 wan 5 nian shi chang jin ru* (Vice President Chen Jianliang of Tianshan Co. Sanctioned RMB 200k Penalties and 5-year Ban in the Market for Insider Trading, XINHUA, May 24, 2007, http://news3.xinhuanet.com/stock/2007-05/24/content_6143588.htm ("Chen Jianliang Insider Trading").

before the information was publicly disclosed.¹⁵⁷ In April 2007, the CSRC found that Chen's action had violated the relevant articles of the *Securities Law* (insider trading) and determined to fine Chen RMB 200,000 yuan¹⁵⁸ and to ban him from participating in China's stock markets for a period of five years.¹⁵⁹ After the 2007 speech of the Deputy Grand Justice of the SPC, an investor who traded Tianshan Co.'s stock around June 21 to June 29, 2004, approached attorney Song Yixin asking him to bring a suit against Chen claiming compensation for his losses, which totaled RMB 9,383.68 yuan.¹⁶⁰ Song filed the complaint in January 2008 in the Nanjing Intermediate People's Court and the court accepted the case in July.¹⁶¹ The case proceeded to the court in September, but plaintiff's lawyer was the only person who appeared for trial.¹⁶² Because Chen's involvement in insider trading had been "established" by the CSRC, the central issues before the court were (a) how to prove causation between the plaintiff's losses and the insider trading in question, and (b) how to calculate the amount of compensation (including whether to consider dividends).¹⁶³

The outcome of this case was unusual. The defendant's attorney appeared in court at one point with a document signed by the plaintiff requesting the withdrawal of the suit, which came as a surprise to plaintiff's own attorney, Mr. Song.¹⁶⁴ Song later disclosed that after the defendant had made various compensation proposals to the plaintiff, the plaintiff decided to request withdrawal of the suit; the request was granted by the court.¹⁶⁵

157. *Id.*

158. Renminbi (RMB) is the currency of China (P.R.C.) and its principal unit is the yuan. Renminbi - Wikipedia, the free encyclopedia, <http://en.wikipedia.org/wiki/Renminbi> (last visited Aug. 27, 2009). In 2007, its exchange rate with U.S. Dollar is roughly 7 yuan per dollar. *Id.*

159. *Chen Jianliang Insider Trading*, *supra* note 156.

160. *Civil Compensations*, *supra* note 155.

161. *Id.*

162. *Id.* Neither the plaintiff, or the defendant, or the defendant's lawyer appeared when the hearing started. *Id.*

163. *Id.*

164. Chinese Law Prof Blog: Wacky insider trading case, http://lawprofessors.typepad.com/china_law_prof_blog/2008/09/wacky-insider-t.html (Sept. 14, 2008).

165. *Civil Compensations*, *supra* note 155.

(3) *Clearing the Hurdles*

The reason this case did make its way into a courtroom in China was because the CSRC had already imposed administrative sanctions on Chen's illegal trading. According to the SPC's circular regarding the hearing of misrepresentation cases,¹⁶⁶ courts may only take a civil compensation case if the claim asserted is based on a prior administrative sanction or a criminal judgment.¹⁶⁷ The SPC imposed this strict requirement on securities cases because of its concern that China's courts lacked both the resources and the special expertise needed to handle these kinds of actions, especially because the number of such cases could potentially be huge.¹⁶⁸ *Securities Law* is a highly technical and specialized area, and Chinese courts are still viewed as not particularly competent to deal with such cases.¹⁶⁹ These concerns are probably legitimate. The solution imposed by the SPC, however, has shut the door to the vast majority of injured investors who would otherwise seek redress in the courts. The CSRC's capacity is limited and the number of administrative sanctions it has imposed is so low that, as the saying goes, they can be counted on one's fingers. Criminal judgments are even more rare. It is not surprising, therefore, that the "prior finding" prerequisite as established by the SPC has been very heavily criticized.¹⁷⁰

While the SPC's restriction issued in the early 2000s was understandable at the time as a temporary measure, presently, pursuant to the later enactment of a more perfected *Securities Law* and in light of the several years of "water-testing" in handling misrepresentation cases, it is now time for the SPC to issue new circulars to lift the ban on insider trading civil actions, and to eliminate the prerequisite of an administrative sanction or a criminal judgment before a court may accept such cases. While these changes must be made, concerns still exist, and many hurdles must be cleared in order for investors to access the courts. The issues which need to be addressed include, for example, who has standing to sue, what evidence is required to prove illegal

166. See *Third Circular*, *supra* note 119.

167. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 124.

168. *Id.* at 125.

169. *Id.* While the situation has improved in recent years, there are still significant numbers of judges in Chinese courts who do not have a formal legal education. Hui Huang, *supra* note 13, at 32.

170. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 125.

insider trading, which party has the burden of proof, how to determine the causal link between the investor's loss and an insider's act, how to calculate the amount of compensation, etc. In Chen's civil case, the plaintiff's attorney argued that the burden of proving causation should be reversed in insider trading cases, i.e., the defendant should have the burden to prove that the plaintiff's losses were not caused by the defendant's illegal trading.¹⁷¹ The court did not rule on this issue because the case was withdrawn by the plaintiff.¹⁷² Nevertheless, this is the kind of issue that courts usually must deal with in hearing civil compensation cases, and while there is still no legislation addressing these issues, the SPC should issue judicial explanations to provide necessary guidance for lower courts.

These are difficult and debatable issues even in the United States;¹⁷³ nevertheless, the issues and problems must be addressed to move forward in its quest to become a safe haven for investors. The SPC, and eventually China's legislature, must learn from the experience of other countries and must work out solutions that will suit China's particular situation. Problems will continue to exist, but laws and regulations can only be perfected in the course of good practice and vigorous enforcement.

E. *The Long-Term Solution—Class Actions*

The prevailing concern that courts will become overburdened with the claims of defrauded investors may, ironically, become a reality if the SPC takes the necessary steps to clear the way for private actions, i.e., the concern is legitimate and can only be successfully addressed by introducing the U.S.-style class action mechanism. By allowing investors harmed by the same securities fraud to "pool their claims together into a single action," the class action represents a more efficient mechanism for enforcement purposes.¹⁷⁴ It certainly plays an important role in insider trading law enforcement in the United States.

171. Wacky insider trading case, *supra* note 164.

172. See *supra* text accompanying note 165.

173. Wacky insider trading case, *supra* note 164.

174. Chenxia Shi, *supra* note 145, at 495 (citing Ames D. Cox, *Protecting Investors in the United States through Multiple Enforcement Mechanisms* 7 (2002), available at <http://www.oecd.org/dataoecd/21/61/2756029.pdf>).

The combined recovery of the losses of numerous investors is significant enough not only to make the class action mechanism financially viable,¹⁷⁵ it will also have a pronounced effect in the area of deterrence. Unfortunately, China still has a long way to go toward the adoption of the class action because its *Civil Procedure Law*¹⁷⁶ still does not recognize class action suits.¹⁷⁷ The *Civil Procedure Law*, however, does provide for “joint actions” in circumstances where many parties have similar claims, either the number of the plaintiffs are ascertained or not ascertained at the time the suit is filed.¹⁷⁸ While adopting the class action mechanism is the best possible means toward effective enforcement of China’s insider trading laws, the joint action, although falling short of class action,¹⁷⁹ can serve as an effective interim measure.

The SPC’s *Third Circular* allowed the joint action in misrepresentation cases, but required that the number of plaintiffs be determined before the case could be heard.¹⁸⁰ This requirement effectively rules out the more useful type of joint action that would allow the court’s judgment or ruling to be applied to plaintiffs who bring their

175. Chenxia Shi, *supra* note 145, at 495.

176. The Civil Procedure Law (promulgated by the Standing Comm. of the Nat’l People’s Cong., Oct. 28, 2007, effective Apr. 1, 2008) (P.R.C.) available in Chinese at http://www.gov.cn/flfg/2007-10/28/content_788498.htm (“*Civil Procedure Law*”).

177. See Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 130. The reason that China is reluctant to introduce the class action is believed to be both political and economic in nature. *Id.* at 154. There are concerns that when a group becomes an interest group, it may invite social trouble and may pose a political threat to the regime. *Id.* Economically, the state still has a great stake in the listed SOEs and the potential massive liabilities entailed from private class actions would hurt the state interest. Han Shen, *supra* note 61, at 31.

178. Wen-Yeu Wang & Chen Jian-Lin, *supra* note 104, at 131. Joint action is similar in some respects to the U.S.-style class action, but is different in regards to the registration requirement, the plaintiffs’ rights, the power of the representatives and the application of the court’s ruling or judgment. SANZHU ZHU, SECURITIES DISPUTE RESOLUTION IN CHINA 176 (2007). For example, the U.S.-style class action requires a claimant to opt out of a litigation to avoid being bound by the judgment. Hutchens, *Supra* note 120, at 642 (2003). China’s joint action, on the contrary, requires a claimant to opt in to a suit before the trial starts. *Id.* at 643.

179. For example, the opt-in requirement for registration will make it harder to group a massive number of claims and the number of defraud investors by one illegal trading is usually huge. Hutchens, *Supra* note 120, at 643.

180. Sanzhu Zhu, *supra* note 118, at 401-02.

suit *after* the joined case has been heard.¹⁸¹ Therefore, the SPC should lift this restriction, because it results in a waste of the court's resources and represents a burden to the defrauded investor.¹⁸² After gaining experience in handling joint actions with an unascertained number of plaintiffs, courts should gradually get on a positive track toward adopting the U.S.-style class action. Although it will take time to accomplish and may first require an amendment to the *Civil Procedure Law*, the adoption of the class action mechanism represents the best long-term solution to China's insider trading law enforcement problem.

CONCLUSION

Insider trading is an extremely serious problem in China. It not only impairs the fairness and integrity of China's stock markets, it also presents a problem for the international financial markets, particularly those in the United States, because increasingly more Chinese companies are listing on U.S. stock exchanges and increasingly more Chinese businessmen serve on the boards of international corporations.

During its brief history of stock market activity, China has made substantial progress in establishing a legal framework for insider trading law enforcement, primarily by learning from the United States' experience. U.S. insider trading law has been developed around Rule 10b-5, and, in its current form, is largely based on the fiduciary-duty-based classical theory and misappropriation theory, as supplemented by both the "short-swing rule" (SEA §16) and the "tender offer rule" (Rule 14e-3). China's insider trading law was put in place through legislation. With a few notable differences, the *Securities Law* closely resembles U.S. law in terms of the scope of "insiders," "insider information," and the activities that trigger liabilities. While U.S. courts need to support their decisions, in enforcement cases, with common law principles and case precedent, China, as a civil law country, is not

181. *Id.* at 402-03 (citing *Civil Procedure Law*, art. 54 (joint action with fixed number of plaintiffs by the time the case is filed), art. 55 (joint action of unascertained number of plaintiffs)). Article 55 may accommodate a potentially large number of claimants, which is often the case in suits arising from insider trading or other securities fraud. *Id.* at 402.

182. *Id.* at 403. With this requirement, investors must make sure they join the action before the case is filed; otherwise, they will not be compensated or will have to incur higher costs to bring separate suits. *Id.*

so constrained nor disposed. China can improve its legal framework and can close many of the loopholes in its laws by amending the *Securities Law* pursuant to a policy consideration and by benefitting (borrowing) from experiences of other countries.

Although loopholes in the law continue to exist, the current iteration of China's *Securities Law* sets up a framework for insider trading law that is essentially comparable to U.S. law. China's serious problem with insider trading is due mainly to its ineffective enforcement mechanisms, which do not serve to deter illegal activities. Also, because of China's unique social culture and its adherence to traditional family values, the society appears to lack the sense of obligation to refrain from insider trading and tipping activities. Frequently, Chinese people are not aware of that their intended activities might violate insider trading laws. Thus, only vigorous education and adequate law enforcement will deter insider trading and will thereby promote public awareness of the illegal nature of insider trading activities.

Presently, China relies heavily, if not entirely, on administrative proceedings instituted by the CSRC to enforce insider trading law. The CSRC's resources are grossly insufficient, both in terms of funding and personnel, as compared to the magnitude and the complexity of the problem. Moreover, the CSRC is inherently conflicted in its enforcement role due to its governmental mandate to protect state assets on the publicly listed SOEs, and its relationships with government officials who are, in many cases, also the corporate officers which it must regulate. These conflicts render the CSRC's enforcement efforts ineffectual in many instances.

There are numerous measures that China might adopt to strengthen its insider trading law enforcement regime. The most important, which would fundamentally change the complexion of the situation, would be to introduce the element of private enforcement as a companion to administrative and criminal enforcement. The experience of the United States has shown that private actions, particular class actions, play an important role in deterring insider trading. In China, the SPC has forbidden courts to accept civil cases arising from insider trading violations due to the concerns that courts have limited resources and that they still lack the expertise necessary to handle often complicated insider trading cases. Additionally, the *Securities Law* does not provide any details on how civil cases would be structured, managed and pursued or how liabilities would be determined.

Having gained valuable experience in dealing with securities fraud cases related to “misrepresentation,” the SPC now appears to be in a position to lift its ban on insider trading cases. It should also eliminate the requirement that courts may only accept private claims on the basis of previously imposed administrative sanctions or criminal judgments, because this restriction closes the door to the vast majority of investors who would otherwise seek redress for their damages, and it defeats the purpose of the private action in deterring insider trading activities. The SPC should also consider providing “guidance” to lower courts by issuing “judicial explanations” regarding how these cases should be heard, and how compensation for claimants should be determined. In order to make private actions efficient and to address the governmental concern regarding the potential overflow of cases, China should also adopt the U.S.-style class action. Class action is a long-term solution because Chinese law still does not recognize this form of civil suit. Joint actions, however, are defined in the *Civil Procedural Law* of China, and thus can serve as a useful interim measure.

By promoting private civil actions and the class action as tools to fight insider trading, China can establish an effective multilevel enforcement regime that would include administrative sanctions, exchange self-regulations, criminal prosecutions, and private actions of several kinds. As a consequence, China could wage an effective battle against insider trading practices. Such a well-developed regime featuring vigorous enforcement will not only deter insider trading, but will also increase the public’s awareness of the existence and importance of insider trading laws. Should these things materialize, cases such as the DJ case involving Mr. Li and Mr. Leung will probably be prevented.

