A Comparative Study of Enforcement of Insider Trading Regulation between the U.S. and China

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I. INTRODUCTION

It is generally thought that protecting investors from act of expropriations by management, either in the form of looting or unfair self-dealing, or in the form of exploitation of management’s inside information in trading securities, is a precondition to the optimal development of public securities markets. The regulation of insider trading, while controversial, is thus a subject of public imperatives. Following the regulation of insider trading in the U.S., the notion of insider trading has been widely introduced to many other jurisdictions, including China.

Certainly, the mere existence of insider trading regulation is not sufficient to assure optimal securities market development; enforcement of insider trading regulation is the key. Recent scholarship concludes that the enforcement of insider trading laws has a strong impact on the cost of capital, whereas passing insider trading laws without enforcing them does not have this effect.

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2 Scholars have developed a series of studies that show both law and its enforcement is key mechanisms to protect investors. They find “[h]ow well investors are protected by law from expropriations by the managers and controlling shareholders of corporations is a common element to the explanation of differences among countries in ownership concentration in publicly traded firms, in the breadth and depth of capital markets, in dividend policies, and in the access of firms to external finance”. See Rafael La, Porta, Lopez-de-Silanes Florencio, et al. (2000), Investor Protection and Corporate Governance, 58 Journal of Financial Economics 3.

3 See Bainbridge, Stephen M. (1999), Securities Law: Insider Trading, Foundation Press, for a thorough discussion of the issues in the debate. Some argue that insider trading does not harm investors and could indeed be an efficient way to increase market efficiency because it produces desirable incentives for corporate managers. See Manne, Henry G. (1966), Insider Trading and the Stock Market, Free Press. Others offer counter-arguments to justify the public regulation of insider trading. They argue that insider trading may create perverse incentives for corporate insiders to enter into risky or ill-advised ventures for short-term personal gain, as well as to put off the public release of important corporate information so that they can capture the economic fruits at the expenses of shareholders. See Schotland, Roy (1967), Unsafe at Any Price: a Reply to Manne, Insider Trading and the Stock Market, 53 Virginia Law Review 1425. In addition, focusing on the principal-agent literature, they argue that shareholders lack “adequate enforcement devices” that can cope with the problems generated by the existence of information asymmetries and the fact that insider trading is virtually undetectable. As a consequence, agency problems emerge. See Easterbrook, Frank H. (1981), Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, The Supreme Court Review 309 at 333-34.

4 A study finds that out of 103 countries that have stock markets, 87 have introduced insider trading regulation. See Utpal, Bhattacharya and Daouk Hazem (2002), The World Price of Insider Trading, 57 The Journal of Finance 75.

5 The study by Bhattacharya and Hazem finds that the cost of equity in a country, after controlling for a number of other variables, does not change after the introduction of insider (…continued)
This paper will principally address the issue of enforcement of insider trading regulation in the People's Republic of China. In doing so, the author frequently refers to the U.S. experience for two reasons: firstly, the U.S. was the first jurisdiction to enact insider trading regulation and today the U.S. continues to lead the world in the regulation and enforcement. The U.S. experience has been largely viewed as the “gold standard” for many emerging markets. Secondly, the U.S. insider trading regulation has served as a core influence on China’s regulatory framework. When the stock markets were established in China in the early 1990s, the regulation primarily imitated the U.S. experience. Rather than developing a costly new regime, China may study how to enhance effective enforcement of existing regulations and may enjoy the learning advantage by adopting the best practices from the U.S. to avoid major pitfalls.

This paper is organized as follows. Part II introduces the development of China’s stock markets and its institutional and regulatory framework on insider trading. Parts III, IV and V review regulations and theories adopted in the U.S. and China, discuss their respective experience to prevent, detect and deter illegal insider trading transactions. Unlike aggressive enforcement actions brought by the U.S. regulators, China has very limited number of cases with forceless deterrence effect. The author will discuss relevant reasons with the analysis of similarities and differences between two markets. Part VI provides suggestions and conclusion.

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(continued…)


6 Henceforward referred to the PRC or China and does not include the Hong Kong Stock Market or the Taiwan Stock Market, because both Hong Kong and Taiwan regulate their stock markets independently.


8 Historically, the U.S. has been the most open of all markets and evolved rich regulatory experience. The U.S. stock markets continue attracting issuers from around the world, which enhanced the importance of U.S. rules as it regulates the world’s largest securities market. The influence of the U.S. rules to other markets is widely found and not a recent phenomenon.


10 According to the author’s view, this is partly because the U.S. model is regarded as the most efficient and successful one and partly because the first several leaders of China Securities Regulatory Commission (CSRC) were educated in the U.S.
II. AN INTRODUCTION OF CHINA’S STOCK MARKETS

A. Overview of China’s Stock Markets

1. The Stock Markets and the Extent of Insider Trading

Compared with more than 200 years’ history of U.S. stock markets, China’s stock markets are quite young. Since the establishments of Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) in the early 1990s, China’s stock markets have made remarkable achievements after many trials and hardships. At December 31, 2006, 1,434 companies were listed on the SHSE and the SZSE. See Table 1.

(Table 1) The number of companies listed on the SHSE and the SZSE from 1999 to 2006.12

At December 31, 2006, China’s stock markets had combined market capitalization of RMB 8.9 trillion (approximately $1.1 trillion).14 At the same time, the New York Stock Exchange (NYSE) had combined market capitalization of approximately $25 trillion.15 In terms of market capitalization, China’s stock markets are much smaller, which only accounts for approximately 4.4% of NYSE. However, the insider trading problem is quite severe. According to Global

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11 The New York Stock Exchange (NYSE) began in 1792 as a result of the Buttonwood Agreement, under which several brokers agreed to trade securities for commissions.


13 See Ibid.

14 In accordance with foreign exchange rate released by Federal Reserve Bank of New York on January 2, 2007, one U.S. dollar equals to RMB7.8.

15 See http://www.nyse.com/about/listed/listed.html.
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; the U.S. index was one of the lowest.  

2. The CSRC

China formulated a centralized securities supervisory system with the implementation of the Securities Law of the PRC in July 1999. The China Securities Regulatory Commission (CSRC), the counter part of the Securities and Exchange Commission (SEC), is the central statutory regulatory body of the securities and futures markets.

3. The Insider Trading Regulatory Framework

While Chinese insider trading law has been heavily affected by the U.S. experience, differences still remain. Unlike the U.S. where the regulation of insider trading largely has been formulated by case laws, China has adopted the codification approach to regulate insider trading. As opposed to common law, the doctrine of precedent does not apply in China.

A four-level national regulatory framework has been developed: the national laws, the administrative regulations, the department rules, and the rules issued by Self-Regulatory Organizations (SROs).  

On the level of national laws, the Chinese Securities Law (2006) is the primary regulation with respect to supervising stock markets. Article 73 generally prohibits persons who possess inside information from using such information to trade securities. Article 74 provides a list of persons who are considered to be “insiders”. Under Chinese law, a holder of more than 5 percent of shares of a

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17 Here, the laws refer to the laws issued by the China National People’s Congress and its standing committee; the administrative regulations refer to the regulations issued by the China State Council; the department rules refer to the rules issued by the ministries and departments under China State Council. See articles 62, 67, 89 and 90 of the Constitution of the People’s Republic of China, promulgated by China National People’s Congress on December 4, 1982.

18 The Chinese Securities Law was effective on July 1, 1999 and significant changes were made on October 27, 2005, which took effective on January 1, 2006.

19 Article 74 includes following insiders: (1) Directors, supervisors, and senior officers of an issuer; (2) Holders of more than 5 percent shares of a company as well as the directors, supervisors, and senior officers thereof, or the de facto controller of a company as well as the directors, supervisors, and senior officers thereof; (3) Companies controlled by an issuer as well as the directors, supervisors, and senior officers thereof; (4) The person of the Company who may take advantage of their positions to obtain any inside information of the company; (5) The staff of securities supervisory agencies and other persons who administer the issuance and trading of (…continued)
listed company is considered as an insider who has to comply with certain obligations, such as prohibition from short-swing transactions, while, under U.S regulation, the threshold is higher, which requires over 10 percent of any equity class of securities of an issuer.\(^{20}\) Article 75 of Chinese Securities Law (2006) generally defines what constitutes “inside information”, as well as itemizes specific events that should be deemed as inside information.\(^{21}\)

On the level of administrative regulations, in 1993 the State Council issued the Provisional Regulations on Oversight of Stock Issuance and Trade

(continued…)

securities pursuant to their statutory functions and duties; (6) The person of the sponsor, securities companies engaging in underwriting, stock exchanges, securities registration and clearing institutions, and securities trading service entities; and (7) Any other person prescribed by the securities regulatory authority under the State Council.

\(^{20}\) Section 16(a) of the U.S. Exchange Act of 1934 defines officers, directors, and holders of more than 10 percent of any equity class of securities as insiders.

\(^{21}\) Non-public information that have material impact on company’s business, finance and stock price is treated as “inside information” under Article 75: (1) The material events provided by paragraph 2 of Article 67 of the Chinese Securities Law (2006); (2) Company’s plan of dividends’ distribution or capital increment; (3) Any major changes in the company’s equity structure; (4) Any major change in company’s debt guaranty; (5) The value of one time mortgaged, sold or written-off assets are more than 30 percent of assets that involved in the business of the company; (6) Any director, supervisor or senior officer of the company may be liable for any major damage and compensation in accordance with law; (7) Acquisition proposals of a listed company; and (8) Any other significant information that has a marked effect on the trading prices of securities recognized by the securities regulatory authority under the State Council.

Article 67 provides a list of “material events”, which includes: (1) A significant change in the business guidelines or business scope of the company; (2) A decision of the company regarding any significant investment or asset purchase; (3) An important contract entered by the company, which may significantly affect company’s assets, debts, rights, or its business developments; (4) The incurrence of any major debts in the company or default on any major debt that is due; (5) The incurrence of any major deficit or major loss in the company; (6) A significant change in the external conditions for the business operation of the company; (7) A change of directors, no less than one-third of supervisors or officers of the company; (8) A considerable change in the holdings of shareholders or de facto controllers, each of whom holds or controls no less than 5 percent 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 in which the company is involved, or where the resolutions of the shareholders’ general meeting or the board of directors have been cancelled or announced invalid; (11) Where the company is involved in any crime, which has been investigated into by the judicial agencies or where any director, supervisor or senior officer of the company is subject to compulsory measures imposed by the judicial agencies; or (12) Any other matter as prescribed by the securities regulatory authority under the State Council.
It is the first nation-wide regulation on securities market and provides certain brief provisions regulating insider trading. On the level of department rules, in 1993 the CSRC issued the Provisional Measures on Prohibiting Securities Frauds (PMPSF). This rule has formulated specific definition of insider trading, insiders and inside information. This rule has adopted the “short-swing transaction” prohibition similar to section 16(b) of U.S. Exchange Act of 1934.

The fourth level of rules is those issued by Chinese Self-Regulatory Organizations (SROs), mainly by the SHSZ and SZSE. These rules govern such matters as reporting of insider trading transactions.

In short, China’s hierarchical regulatory framework on insider trading has been established and gradually evolved. The key task remains to make sure the consistency between enforcement and the letter and the spirit of the law.

B. Salient Features of China’s Stock Markets and Its Efficiency

China’s stock markets were introduced to improve the economic performance of the state sector so as to relieve the Chinese government from continuing need to subsidize the deeply troubled state owned enterprises (SOEs). As a result, any discussion related to China’s stock markets must inevitably touch upon the issues of government intervention and state dominated

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22 The PROSIT became effective on April 22, 1993.

23 See Article 72 of the PROSIT.

24 The PMPSF became effective on September 2, 1993.

25 Section 16(b) of the Exchange Act prohibits short-swing profits (from any purchases and sales within any six month period) made by corporate directors, officers, or stockholders owning more than 10 percent of a firm’s shares. Illegal profits gained from short-swing transactions are subject to be disgorged. China regulates the same way, except for requiring “stockholders owning more than 5 percent of a firm’s shares.”

26 SOEs were not only production units in China, but they also carried out social and political functions. Most SOEs were static and uncompetitive, as well as greatly restrained by financial sources. Chinese policymakers were well aware that it was increasingly urgent to shed government’s responsibility from SOEs’ management and loss so as to improve their efficiency and productivity. It was increasingly difficult to continue government free loans to SOEs as these loans were never repaid by SOEs; however, if SOEs were cut off from state funds, most of them would be pushed into bankruptcy, causing widespread layoffs. The Chinese policymakers had to find a solution to the dilemma and, finally, they found it in the stock market. See Zhang, Xianchu (1999), The Old Problems, The New Law, And the Development Market-A Preliminary Examination of the First Securities Law of the People's Republic of China, 33 International Lawyer 983, at 985.
ownership. Certainly, these features of Chinese economy lead to many unique practices and regulations of China’s stock markets.\(^{27}\)

(a) Majority Non-tradable Shares

To ensure state control over the stock markets,\(^{28}\) nearly 2/3 of the total shares of Chinese listed companies cannot be traded on the stock markets. On average, the larger the size of the company, the higher the percentage of state shares, which demonstrates that large listed companies are essentially state-owned.\(^ {29}\) See Table 2.

(Table 2) Percentage of non-tradable shares of total shares of listed companies from 1992 to 2006\(^ {30}\)

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\begin{array}{ccccccccccccccccc}
69.3 & 72.2 & 67 & 64.5 & 64.8 & 65.4 & 66.9 & 65.1 & 64.3 & 65.3 & 65.3 & 64.3 & 63.9 & 61.8 & 62.2 \\
\end{array}
\]

It is very difficult for investors to obtain control of Chinese listed companies by a tender offer, which is a common means to change control in the

\(^{27}\) In the U.S., stock markets play a vital role in the formation of capital. They can effectively allocate resources through competition driven by the supply and demand of capital resources. Capital flows towards the most profitable enterprises until a balance is reached between supply and demand. As a result, the country can derive the maximum benefits from its resources. A healthy, diversified stock market offers investors greater investment opportunities and leaves a nation’s capital resources unconstricted. See Nuttle, Robert (1993), The Development of the Securities Market in China in 1990s, 11 Company and Securities Law Journal 503.


\(^{29}\) A majority of listed companies’ non-tradable shares are 60%-80% of their total number of shares. A few companies even have more than 90% shares not tradable. About 6% of all the listed companies have more than 40% of their total equity in tradable shares. 0.4% of all listed companies have only tradable shares. See Hu, Ruyin (2005), Corporate Governance of the State Controlled Listed Companies in China: Problems, Progress and Prospects, from www.oecd.org/dataoecd/15/9/34972057.ppt.

U.S market. As a result, change-in-control transactions are rare and hostile takeovers yet unheard of in the PRC.

(b) The Share Classification System

Unlike the general practice in the U.S. where corporations are allowed to issue two kinds of shares, common shares and preferred shares, holding the philosophy that “all shares are equal”, China has introduced a share classification system that listed companies have classified their shares into three parts based on the ownership: state shares, legal person shares and public shares. State shares and legal person shares cannot be traded on the stock markets which leads the problems of inequality among shareholders. This system has distorted the fair pricing function of an efficient stock market and creates different prices for securities of the same equity.

(c) Dominance of A Single Shareholder

The third characteristic of China’s stock markets is the dominance of a single shareholder and the state often plays this role. On average, a single shareholder dominates approximately 45% shares in China’s listed companies.

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31 The distinction between common shares and preferred shares arises as a result of the investors’ dividend expectations, voting rights and priority in liquidation. Apart from these differences, shareholders of each class of shares are entitled to equal rights and equal benefits, irrespective of their origin and citizenship. See Friedman, William I (2002), One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market, 27 Brook Journal of International Law 477, at 495.

32 State shares are those held by the central government, local governments, or solely-government-owned enterprises and the ultimate owner of state shares is the state.

33 Legal person shares are the shares owned by any institution, which has legal personality according to the law.

34 Public shares mainly refer to A shares and B shares. A shares are Chinese companies’ shares denominated in RMB and listed on either the SHSE or the SZSE. At present, A shares occupy the largest segment of all tradable shares. B shares are Chinese companies’ shares listed on the SHSE or the SZSE and denominated in U.S. dollars on the SHSE or Hong Kong dollars on the SZSE, respectively.

35 In a study by Chen Zhiwu and Peng Xiong, because these shares are non-tradable, they are priced at an average discount of 86% to the otherwise identical publicly traded A shares. Chen and Peng conclude that this pricing and liquidity distortion is also a source of corporate governance problems in Chinese listed companies. See Chen, Zhiwu and Xiong Peng(2001),Discounts for Illiquid Stocks: Evidence from China, from http://papers.ssrn.com/sol3/delivery.cfmSSRN_ID286169_code011015590.pdf?abstractid=286169.

Such a high percentage of state ownership does not exist in the U.S. or any other stock markets in the world. Critics argue that the existence of this state dominant shareholder structure has led to the exploitation of minority shareholders and a negative role in the development of listed companies.

The features of majority non-tradable shares, the share classification system and dominance of a single shareholder greatly impeded the market efficiency of China’s stock markets. It is known that the more efficient the market, the more accurate the share price and the less opportunities to take advantage of non-public information. These unique features of China’s stock markets created negative impact on market efficiency and effectiveness of insider trading regulation and enforcement.

III. PREVENTION OF ILLEGAL INSIDER TRADING TRANSACTIONS

In the U.S., theories of insider trading have been developed primarily through a number of judicial opinions, some of which were issued even earlier than the promulgation of the Exchange Act of 1934. Principal theories that have been used to rationalize a prohibition on insider trading include: (1) the equal access theory; (2) the fiduciary duty theory; and (3) the misappropriation theory.

Statutory support for the judicial development of an insider trading prohibition was found in section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, the general “catch-all” antifraud provision. Section 10(b) provides:

37 Ibid.


41 Back in 1909, the U.S. Supreme Court held that a corporate insider who knew the price of company’s stock was about to jump up committed fraud when he bought the stock from uninformed outsiders. See Strong v. Repid, 213 US 419 (1909).
“[I]t shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange: …(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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.”

Rule 10b-5, promulgated under Section 10(b), makes it unlawful for:

“[A]ny person, directly or indirectly, by the use of any instrumentality of interstate commerce . . . 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.”

More recently, the U.S. has developed a number of supplementary statutory rules, such as The Insider Trading Sanctions Act of 1984 (ITSA); The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA); The Securities Enforcement Remedies and Penny Stock Reform Act of 1990; Rule 14e-3 Tender Offer Rule, Regulation FD, as well as the Sarbanes-Oxley Act of 2002. More details of these rules will be explored in the rest part of this paper when a specific legal issue is discussed.

A. Equal Access Theory v. Fiduciary Duty Theory

The equal access theory originated from Cady, Roberts & Co 42 which was the first SEC enforcement action to address insider trading on the open market and built the foundation on which the modern law of insider trading rested. 43 The SEC held that “a corporate insider must disclose all material nonpublic information known to him before trading, or if disclosure is improper or impracticable, abstain from trading.” The scope of this theory was extended from “a corporate insider” 44 to “anyone” by the landmark case of SEC v. Texas Gulf Sulphur. 45 The court held that “anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed.” 46


46 See Ibid.
The aggressive interpretation of *Texas Gulf Sulphur* however did not meet with complete acceptance by late courts. In *Chiarella v. United States*, the Supreme Court removed equal access theory by the fiduciary duty theory, also known as classical theory and the scope of insider trading was substantially narrowed. The Supreme Court of *Chiarella v. United States* held that duty does not arise from mere possession of nonpublic material information. Instead, there must be a fiduciary or other similar relationship of trust and confidence between the trader with inside information and the plaintiff. The Supreme Court further clarified the limits of the fiduciary duty theory by addressing the liability of tippees in *Dirks v. SEC*. According to Dirks decision, the recipient of material, non-public information must abstain or disclose if the provider of the information breached his or her fiduciary duty to shareholders by benefiting from the tip.

On the contrary, China opts for an insider trading theory premised on the notion of equal access theory and does not adopt the fiduciary duty theory. In accordance with Article 76 of the Chinese Securities Law (2006):

“prior to the public disclosure of inside information, a person who has knowledge of inside information on securities trading or a person who illegally obtains such information cannot purchase or sell such securities, divulge such information, or counsel another to purchase or sell such securities.”

As we know, the fiduciary duty theory relies on a fiduciary or other similar relationship of trust and confidence between the parties to the transaction. In the U.S., fiduciary duties are judge made principles, invented and refined in judicial decisions spanning over a century. Judges are guided by principles enunciated by prior court opinions based on particular facts. However, the fiduciary duties are underdeveloped in Chinese laws. It is widely known that before the revision of Chinese Company Law (2006), the norm of fiduciary duty

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48 Under equal access theory, it is capable of reach all misconducts related to insider trading and victims of insider trading are easily identified. This approach was ended in *Chiarella v. United States*. The court held that printer who had traded on preknowledge of pending takeover bids did not breach a disclosure duty to other traders because he lacked a relationship based duty to shareholders of companies in whose securities he traded. The concern is the risk of chilling social useful trading; it is unclear why the “unfairness” arising from trading on access to superior information defrauds other traders in the absence of misrepresentation or a preexisting disclosure duty. Investors continuously exploit differential access to information; indeed, the effort to profit from such disparities is precisely what keeps securities prices informed. See Allen, William T. and Reinier Kraakman (2003), Commentaries and Cases on the Law of Business Organization, Aspen Publishers, Inc., at 606.

49 See *Ibid*.


did not exist in the Chinese legal system.\textsuperscript{52} However, the revised law still has no words on fiduciary liabilities when a director breaches his duty.\textsuperscript{53} Enforcement will be very problematic without a well-established and sound understanding of fiduciary duties concept among Chinese courts where enough experienced and knowledgeable judges are always in high demand.

Moreover, the fiduciary duty theory itself has certain shortcomings and has entailed controversies.\textsuperscript{54} It also has not been well received in many other jurisdictions, including U.K. and continental European countries, where are generally adhered to the “equal access theory”.\textsuperscript{55} Supporters for equal access theory are not only found in jurisdictions outside the U.S., but also within the U.S. For instance, the SEC has promulgated Rule 14e-3 in the tender offer context on the basis of the equal access theory.\textsuperscript{56}

Taken as a whole, the equal access theory seems more appropriate for China and it will be easier for China’s courts to enforce it under current legal system.

\textbf{B. The Misappropriation Theory}

In the U.S, the misappropriation theory was upheld by the Supreme Court in the \textit{O’Hagan} case,\textsuperscript{57} which extends liability to those who trade on the basis of “inside information” misappropriated from a third party in breach of fiduciary duty or similar relationship of trust and confidence, whether or not the trader owns an independent fiduciary duty of disclose to whom he transacts. The

\textsuperscript{52} See Article 148, the Chinese Company Law (2006).

\textsuperscript{53} See Article 148, the Chinese Company Law (2006) for the first time introduces the concept of fiduciary duty by stating: “The directors, supervisors and senior officers shall comply with the laws, administrative regulations, and articles of association. They shall bear the obligations of fiduciary and diligence to the company. No director, supervisor or senior officer may take any bribe or other illegal gains by taking the advantage of his powers, or encroach on the property of the company.”

\textsuperscript{54} See Steinberg, Marc I. (2003), Insider Trading: A Comparative Perspective, 3 Current Developments in Monetary and Financial Law 38.

\textsuperscript{55} See ibid.

\textsuperscript{56} See Huang, Hui (2005), The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform, 17 Australian Journal of Corporate Law 281, at 317. Rule 14e-3 places a duty on anyone who obtains inside information about a tender offer to disclose or abstain from trading. It is fair to say that the equal access theory was reasserted in this rule with respect to tender offers.

misappropriation theory became one of the major enforcement weapons of the SEC against insider trading, in particular, towards these outside traders.

Misappropriation theory can also be found in Chinese law. Article 76 of the Chinese Securities Law (2006) requires:

“a person who illegally obtains inside information on securities trading…cannot purchase or sell such securities, divulge such information, or counsel another person to purchase or sell such securities.”

In accordance with Article 76, there is no requirement of a trust or confidence relationship between the misappropriator and the source of the information. From this aspect, the scope of liability under Chinese law is much wider than that of the U.S. regulation, primarily due to the underdeveloped fiduciary duty doctrine in China’s legal system.

Both the U.S. and China prohibit illegal insider trading by traditional corporate insiders and extends liability to those who have misappropriated information. Overall, China’s insider trading regulation is a work in progress and existing rules generally fit China’s legal and economic landscape, though shortcomings still remain.

IV. DETECTION OF ILLEGAL INSIDER TRADING TRANSACTIONS

There are various methods to detect illegal insider trading transactions. This part will introduce three major methods found both in the U.S. and China: (1) Referrals from the stock exchanges; (2) Investigations by the regulators;58 and (3) Informants.

A. Referrals from the Stock Exchanges

An important cornerstone of the U.S. effective enforcement against illegal insider trading is the commitment of the stock exchanges, operating in the front line to monitoring market transactions.

In the U.S., advanced technologies play a critical role of monitoring day-to-day market transactions. For example, the NASD has developed a system called SONAR.59 When there is a price movement in a particular stock that

58 Here primarily refer to the SEC and Department of Justice in the U. S or the CSRC and the people’s procuratorate in China.

59 SONAR is an intelligent surveillance application, which is called the Securities Observation, News Analysis and Regulation system and automatically monitors the NASDAQ, OTC, and futures markets for suspicious patterns. The SONAR processes between 8,500 and 18,000 news wires stories, approximately 1,000 quarterly and annual SEC filings from (…continued)
exceeds predetermined parameters, an “Alert” will be generated by SONAR which will be further reviewed by several groups of regulatory analysts and investigators. The system generates around 50 to 60 alerts per day and a number of these are referred to the SEC for further investigation. The NYSE also uses sophisticated technology and pattern recognition system to monitor volume and price movements of all publicly traded stocks on a real-time basis. Where there is sufficient circumstantial evidence of insider trading and where the powers of the stock exchange are inadequate for inquiring into or addressing it, a referral will be made to the SEC.

NYSE referrals to the SEC increased from 68 in 2004 to 111 in 2005, a 63% increase. In 2005, NYSE referrals resulted seven SEC enforcement actions, representing 14.2% of SEC enforcement actions against insider trading and resulted in approximately $4 million in profit disgorgements, fines and penalties.

(continued…)

corporations, and evaluates price-volume models for over 25,000 securities. See PR Newswire (September 17, 2003), Monitoring NASDAQ for Potential Insider Trading and Fraud: Artificial Intelligence Used for Market Surveillance.

For example, the analyst will monitor that stock to see if any unusual news announcements are made by the company. When there is an unusual amount of trading prior to a major news announcement, the stage is set for an insider trading investigation.

PR Newswire (September 17, 2003), Monitoring NASDAQ for Potential Insider Trading and Fraud: Artificial Intelligence Used for Market Surveillance.


To ensure the misconduct to be identified at an early stage, an electronic communication will be sent to the SEC via the Self Regulatory Organization Investigation Referral System, which also notifies other SROs. According to Robert Marchman, Executive Vice President of NYSE, not all matters reviewed by NYSE result in a referral to the SEC. Only matters that NYSE believes warrant further review are the subject of a referral. Similarly, not all NYSE referrals to the SEC result in enforcement action by the SEC. NYSE refer matters to the SEC where there is sufficient evidence demonstrating that a person engaged in insider trading is substantial. See Ibid.

See Ibid.


In recent years, the Shanghai Stock Exchange and the Shenzhen Stock Exchange have also imported advanced market surveillance software systems from the U.S. with the purpose to effectively track illegal transactions. It is too early to access whether these advanced technologies can effectively monitor volume and price movements of all publicly traded shares to detect uncommon insider trading transactions. Unlike the semi-strong efficient stock markets in the U.S, the degree of efficiency of China’s stock markets is still controversial, either in weak form or not efficiency form. Even we assume that China’s stock markets is in weak form efficiency, i.e. prices reflect all information about past price history, share price cannot timely reflect current market information and in many cases, it will delay. Therefore, the advanced technologies cannot play the same role as those in the U.S. market and may not help Chinese regulators to detect illegal transactions on a timely basis.

B. Investigations by the Regulators

1. Non-Criminal Investigations

Similar to the stock exchanges, the SEC also monitors market trading through online data and review of periodical filings. In 2005, referrals from

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70 The SEC’s Division of Enforcement may receive referrals from the examination staff and the Division of Corporation Finance’s disclosure review program which strive to uncover serious potential violations of the federal securities laws, among other objectives. When possible violations are found, they are referred to the Division of Enforcement for further investigation.
internal departments of the SEC amounted to 1,039.\textsuperscript{71} The Division of Enforcement of SEC conducts two levels of investigations, informal and formal.\textsuperscript{72} An informal investigation is an SEC request for information, and at this point, the SEC staff requires information on a voluntary basis and does not have subpoena power.\textsuperscript{73} Meanwhile, the SEC does not publicly disclose the initiation of an investigation.\textsuperscript{74} Table 3 shows the number of informal investigations opened by the SEC from 1999 to 2005.\textsuperscript{75}

<table>
<thead>
<tr>
<th>Year</th>
<th>Investigations Opened</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>520</td>
</tr>
<tr>
<td>2000</td>
<td>558</td>
</tr>
<tr>
<td>2001</td>
<td>570</td>
</tr>
<tr>
<td>2002</td>
<td>479</td>
</tr>
<tr>
<td>2003</td>
<td>910</td>
</tr>
<tr>
<td>2004</td>
<td>950</td>
</tr>
<tr>
<td>2005</td>
<td>947</td>
</tr>
</tbody>
</table>

A formal order of investigation will be issued by the SEC when it finds sufficient reason to believe that fraud did occur. The formal order allows the SEC to issue subpoenas that provide greater access to company documents and executives. A formal order may also be issued without a prior informal investigation. In 2005, the SEC carried out 629 formal investigations, which increased by 123.0\% compared to 282 in 1999 and 109.7\% compared to 300 in

\begin{itemize}
  \item Both kinds of investigations can lead to so-called “enforcement proceedings.” Both kinds of investigations can also lead to no action at all.
  \item However, if SEC staff runs any roadblocks in obtaining information, it may seek civil subpoenas from the SEC.
  \item Companies will disclose SEC informal investigation primarily through press release and some also disclose this information through 8-Ks, quarterly reports or annual reports. See McDowell, John(2005). A Look at the Market’s Reaction to the Announcements of SEC Investigations, from w4.stern.nyu.edu/glucksman/docs/McDowell_2005.pdf.
  \item See SEC Annual Reports from 1999 to 2005 at http://www.sec.gov/about/annrep.shtml.
\end{itemize}
As a result of such extensive investigations, the SEC detected quite a number of insider trading cases each year. See Table 4 below.

(Table 4) Insider Trading Cases Detected by the SEC from 2001 to September 22, 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006 (as of September 22, 2006)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Insider Trading Sanctions</td>
<td>57</td>
<td>58</td>
<td>50</td>
<td>41</td>
<td>49</td>
<td>45</td>
<td>243</td>
</tr>
</tbody>
</table>

Almost in the same period, the CSRC has brought 174 administrative sanctions against various frauds on the securities markets, however there was only one sanction related to insider trading, representing 0.6% of all the CSRC administrative sanctions. This percentage is extremely low. Table 5 provides a summary of the CSRC’s administrative sanctions from 2002 to November 6, 2006.

(Table 5) Administrative Sanctions by the CSRC from 2002 to November 6, 2006.

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006 (at November 6, 2006)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of the CSRC Administrative Sanctions</td>
<td>17</td>
<td>40</td>
<td>49</td>
<td>43</td>
<td>25</td>
<td>174</td>
</tr>
<tr>
<td>Number of Insider Trading Sanctions</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

There are many reasons to explain the inefficiency of the CSRC’s investigation.

First, one fundamental reason is the CSRC’s dual role: on one hand, the CSRC has political task to provide the SOEs with preferential access to financial

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78 This one insider trading sanction is the case of Xiang Xiaoyun (CSRC[2004]17).

79 The CSRC only publishes its administrative sanctions on its website since 2002. Data of 2001 is unavailable.
resources of the capital market for the best interests of the government; on the other hand, the CSRC, like many other regulators, has the regulatory mission to protect investors. The CSRC, as a security guard for the state assets, makes it necessary to postpone required enforcement actions that may cause negative influence on state shares and assets.

Second, the resources of the CSRC are insufficient; especially with respect to investigation powers required an order to take timely action to stop frauds. For example, unlike the SEC, the CSRC cannot take civil enforcement actions nor can it directly bar officers and directors from their positions; instead, it generally suggests to the listed company that it remove wrongdoers from their positions. The Chinese Securities Law (2006) has made progress to empower the CSRC to freeze or seal corporate or individual capital, securities and bank accounts in cases of suspected illegal insider trading activities and the CSRC may further suspend the trading activity of persons suspected of insider trading for 15 days. Where the case is complicated, the suspension could be extended by a further period of up to 15 trading days. The revised law aims to give the CSRC true enforcement

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80 In theory, a company that meets the requirements of the PRC laws may be listed on the stock markets. In practice, the CSRC gave favorable considerations to these SOEs for listing. They once introduced a quota system to limit the number of IPO companies. Under the quota system, the majority of Chinese listed companies were restructured and transformed from previous SOEs or other government controlled entities. Although the quota system was ended in 2000, China’s stock markets are still suffering from this system, with many poorly performed SOEs listed on the markets.

81 See article 180, the Chinese Securities Law (2006). It authorizes the CSRC following rights: “Where the securities regulatory authority under the State Council performs its duties and functions, it has the power to take the following measures: (1) Carrying an on-the-spot examination to a securities issuer, listing company, securities company, securities investment fund management company, securities trading service company, stock exchange or securities registration and clearing institution; (2) Making investigation and collecting evidence in a place where any suspected irregularity has happened; (3) Consulting the parties concerned or any entity or individual relating to a case under investigation and requiring the relevant entity or person to give explanations on the matters relating to a case under investigation; (4) Referring to and photocopying such materials as the registration of property right and the communication records relating to the case under investigation; (5) Referring to and photocopying the securities trading records, transfer registration records, financial statements as well as any other relevant documents and materials of any entity or individual relating to a case under investigation; (6) Consulting the capital account, security account or bank account of any relevant party concerned in or any entity or individual relating to a case under investigation; in the case of any evidence certifying that any property as involved in a case, such as illegal proceeds or securities, has been or may be transferred or concealed, or where any important evidence has been or may be concealed, forged or damaged, freezing or sealing up the foregoing properties or evidence upon the approval of the principal of the securities regulatory authority under the State Council; (7) When investigating into any major securities irregularity such as manipulation of the securities market or insider trading, upon the approval of the principal of the securities regulatory authority under the State Council, restricting the securities trading of the parties concerned in a case under investigation, whereby the restriction term shall not exceed 15 trading days; under any complicated circumstance, the restriction term may be extended for another 15 trading day.
power to fulfill its tasks. However, in light of enforcement activities brought by the CSRC so far, it is too early to comment on whether these new powers would significantly improve the CSRC’s enforcement activities.

Third, the current resources allocated to the CSRC are grossly inadequate. CSRC’s funding is traditionally from the government; it covers only salaries and certain administrative expenses. Highly qualified personnel can continue with the CSRC only at continued personal sacrifice. In the U.S, the Sarbanes-Oxley Act increased the SEC’s budget by approximately 50% in 2003 and such increased funds are continuous with approximately $100 million each year. Table 6 shows increasing budget of the SEC from 1999 to 2005. With enough funding, the SEC has attracted and retained talented employees and its staff turnover rate is just around 6.9% in recent 5 years.

(Table 6) SEC Financial Resources from 1999 to 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>SEC Financial Resources (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>356</td>
</tr>
<tr>
<td>2000</td>
<td>382</td>
</tr>
<tr>
<td>2001</td>
<td>427</td>
</tr>
<tr>
<td>2002</td>
<td>515</td>
</tr>
<tr>
<td>2003</td>
<td>716</td>
</tr>
<tr>
<td>2004</td>
<td>812</td>
</tr>
<tr>
<td>2005</td>
<td>913</td>
</tr>
</tbody>
</table>

Fourth, the CSRC has been hampered by the shortage of supervisory personnel. The staff is small compared to its tasks. Resources allocated to the CSRC enforcement, which comprise only 40 dedicated staff, are inadequate.

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84 Before 2006, China’s stock market was primarily based on market-based supervision, which means the CSRC must enforce merit requirements, with an attempt to ensure the investment quality of business. On the other hand, the U.S. securities regulation is disclosure-based regulation. The main task of the SEC is not expected to be a guarantor of corporate profits. See Clarke, Donald C (2003), Corporate Governance in China: An Overview, 14 China Economic Review 494.

Even in the year of 2001, which was popularly called “the supervision year”, there were only about 200 investigators. Lacking sufficient financial and human resources, even the most rigorous law would have a limited impact on the market. The U.S. has made constant efforts to increase its staff and resources. Shortly after Enron-type scandals, the SEC received the authority to hire more than 840 new staff in February 2003. At September 30, 2005, the SEC had approximately 3,865 staff members increased from approximately 405 in 2002. As a result of recent increases in staff and resources, the SEC significantly improved its efforts to enforce compliance with the federal securities laws. As a matter of fact, we see growing number of the SEC’s inspecting regulated entities to promote compliance and uncover violations, and investigating and litigating violations of law. It is true that the U.S. capital markets are much more developed and larger, but when taken their difference into account, the CSRC appear undoubtedly under-supported.

What’s more, it is generally thought that insider trading is difficult to detect. With limited financial and human resources, the priority of the CSRC investigation will be placed on other less difficult cases such as misrepresentation and material omission. As a result, such cases account for approximately 88% of the CSRC enforcement actions. The SEC distributes its efforts across all core enforcement areas and no single category exceeds 40% of the total, which has more effective deterrence on securities frauds.

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86 In 2001, the CSRC has adopted a number of new laws and regulations as well as enhanced its enforcement actions by punishing more market frauds.

87 See China Daily (December 31, 2001), "Year of Supervision" for China's Stock Market.


91 The Shenzhen Stock Exchange has conducted a research report, which studied 218 cases of punishment of 171 Chinese listed companies from 1993 to October 2001. It found that detected and punished irregularities of Chinese listed companies are primarily related to material omission and false disclosure, accounting for more than 88%. See SZSE No. 0051, The Shenzhen Stock Exchange Report (2002), ZHONGWAI XINXI PILU ZHIDU JI SHIJI XIAOGUO BIJIAO YANJIU (Comparative Study of the Information Disclosure System and Effects)[ Research Report No.0051], http://www.cninfo.com.cn/finalpage/2002-04-23/590499.PDF.

2. Parallel Investigations

The U.S. and China both maintain parallel investigations between civil and criminal regulators. Although the SEC is very powerful, it may never seek criminal penalties during the course of an investigation. Should the preliminary inquiry indicate there may have been illegal trading by insiders, SEC staff may refer a matter to the Department of Justice (DOJ) for investigation, and DOJ may conduct its criminal investigations parallel to the SEC’s civil investigations. The DOJ typically will then request access to the SEC investigative materials, including documents and testimonies properly obtained in the civil cases.\textsuperscript{93} Information shared between the DOJ and the SEC make investigations and prosecution of these parallel matters more efficient and effective. Professor John Coffee of Columbia University believed that “[t]his ability of the civil authorities to aid and assist the criminal enforcer is critical to effective law enforcement.”\textsuperscript{94}

Table 7 shows constant efforts made by the DOJ on the investigation of criminal insider trading.\textsuperscript{95}

(Table 7) Investigations by the DOJ on Criminal Insider Trading from 2001 to 2006

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
Year & Pending cases & Indictments & Convictions \\
\hline
2001 & 14 & 52 & 53 \\
2002 & 16 & 52 & 52 \\
2003 & 16 & 51 & 51 \\
2004 & 15 & 53 & 53 \\
2005 & 14 & 67 & 67 \\
2006 & 15 & 24 & 24 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{93} However, this relationship does not allow either the SEC or DOJ to circumvent the protections afforded defendants. Each side must collect information in conformity with existing protections, such as a defendant’s privilege against self incrimination in connection with testimonial evidence.

\textsuperscript{94} See Coffee, John(2006),Illegal Insider Trading: How Widespread is the Problem and is there Ad, from http://judiciary.senate.gov/testimony.cfm?id=2405&wit_id=5780.

China has adopted parallel investigation system similar to that in the U.S. The CSRC is responsible for administrative enforcement actions and the people’s procuratorate is responsible for criminal investigations. In general, the prosecutors are unlikely to take securities frauds cases as seriously as, for instance, murders or robberies. What’s more, prosecutors currently often lack sufficient knowledge of the how financial markets function to investigate an insider trading case effectively. As a result, there have been very few criminal insider trading investigations reported in China.

C. Informants

In a typical insider trading investigation, informants, such as information from anonymous calls, market professionals, disgruntled employees, and competitors, are important sources of information for the regulators to carry forward their investigations.

The SEC has adopted a bounty program which may pay a bounty of up to 10% of the penalty to private individuals who provide information leading to the imposition of such penalty. Moreover, the Sarbanes-Oxley Act further enhanced whistleblower protection to make it clear that retaliation against whistle-blowers will not be tolerated. It created criminal liability for one who “knowingly with intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person” for providing truthful information to a law enforcement officer relating to the possible commission of any federal offense. The punishment can be a fine up to $250,000 or up to 10 years in prison.

The CSRC announced its bounty program in June 2001. In making determinations regarding how much should be paid, the CSRC consider the importance of the information: generally, an award is up to RMB 3,000 (approximately $375); if the information leads to the detection of big fraud, an award can be up to RMB 20,000(approximately $2,500). If the information is significant, a much bigger amount of award, at the CSRC’s discretion, will be provided.


97 §21A(e) of the Exchange Act.

98 See section 1107 of the Sarbanes Oxley Act of 2002.

99 See “Notice of Improving Bounty Program on Illegal Trading of Securities and Futures” issued by the CSRC on June 24, 2001.
Compared with the SEC bounty program, the amount of award in China is not based on the percentage of penalty which may create less incentive for informants. However, when taken China’s economic condition into account, the current CSRC standard works. According to data published by the National Statistics of China, average personal monthly income is RMB1047.54 (approximately $134) at November 2006. The CSRC may adjust its standards in accordance with China’s economic development in future.

V. DETERRENCE OF ILLEGAL INSIDER TRADING TRANSACTIONS

Each year, the SEC brings approximately 50 enforcement actions against insider trading and the DOJ brings approximately 18 indictments. Compared with harsh approaches conducted by the U.S. regulators with outcome of over 300 enforcement actions against illegal insider trading transactions since 2001, China only has approximately 12 public reported insider trading cases in its 15 years’ stock market history.

It is true that China’s stock markets are much smaller than that of the U.S. However, reported insider trading cases in China only accounts for extremely small percentage of those of U.S. For the period between 2001 and 2005, the SEC and the DOJ has brought approximately 271 enforcement actions; while in China, the total number is 3, representing 1.1%.


104 Data is as of November 30, 2006. Data before January 1, 2002 is from Shenzhen Stock Exchange(2005), Zhongguo Zhengquan Shichang Zhuyao Weifa Weigui Xingwei de Shibie he Fangfan Yanjiu (A Study of the Major Misconducts on China's Securities Market), from www.szse.cn/UpFiles/Attach/1883/2005/03/22/1123007187.doc. This study has been awarded first prize by the Shenzhen Stock Exchange among all its research projects in 2005. Data after January 1, 2002 is collected from the CSRC website under Administrative Announcement section, where provides all the administrative sanctions made by the CSRC since January 1, 2002. This number does not include additional a few cases that may involve insider trading allegations but are more appropriately given another primary classification, such as market manipulation.

105 The number of listed companies in China accounts for approximately 23.5% of the total sum of listed companies at NYSE and NASDAQ at the end of 2005.
As a matter of fact, any one who has some knowledge of China’s stock markets will believe this number substantially understated the real insider trading incidents in China. In January 2001, Wu Jinglian, head of the State Council’s Development Research Council, openly condemned China’s stock markets for being “worse than a casino”—a paradise for speculators.\(^{106}\) It is reasonable to believe that many insider trading cases in China haven’t been detected, prosecuted or punished. Table 8 lists major insider trading cases in China from 1993 to 2006.\(^{107}\)

(\textit{Table 8}) Major insider trading cases in China from 1993 to 2006

<table>
<thead>
<tr>
<th>Case Number</th>
<th>Name of Case</th>
<th>Material Inside information</th>
<th>Administrative Sanctions</th>
<th>Criminal Sanctions</th>
<th>Civil Sanctions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CSRC[1993]99</td>
<td>Huayang &amp; Longgang</td>
<td>short-swing</td>
<td>yes</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>2. CSRC[1994]13</td>
<td>Xiangfan Trust and Investment Company (Shanghai Branch)</td>
<td>M&amp;A</td>
<td>yes</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>3. CSRC[1998]32</td>
<td>Minyuan Hainan</td>
<td>Dividends distribution</td>
<td>yes</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>5. CSRC[1999]36</td>
<td>Dai Libai</td>
<td>M&amp;A</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>7. CSRC[1999]20</td>
<td>China Qingqi Group</td>
<td>M&amp;A</td>
<td>yes</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>8. CSRC[1999]28</td>
<td>Nanfang Securities</td>
<td>Capital increase; Dividends distribution; material investment</td>
<td>yes</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>10. CSRC[2001]12</td>
<td>Zhangjiajie Tourism Development Company</td>
<td>Allotment of shares</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>11. Shenzhen Luohu People’s Court[2003]115</td>
<td>Ye Huanbao &amp; Gujian</td>
<td>Material investment</td>
<td>yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. CSRC[2004]17</td>
<td>Xiang Xiaoyun</td>
<td>Issuance of new shares</td>
<td>yes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


\(^{107}\) See supra note 104.
A. Administrative Enforcement

One distinctive feature of China’s legal system is that it is not separate from, or independent of, the administrative system. In addition, civil remedies have been ignored for a long time. This feature will no doubt affect the enforcement of insider trading regulation. Unlike the SEC who may initiate two basic kinds of enforcement proceedings, i.e. administrative proceedings and civil proceedings, the CSRC can only bring administrative actions. Even in its administrative sanctions, the CSRC’s power to punish illegal insider trading is quite limited. For example, it cannot bar officers and directors but just suggest listed company to remove them from positions.

The monetary punishment imposed by the CSRC is not severe. All CSRC’s administrative sanctions were forced before 2006. Article 183 of Chinese Securities Law (1999) provides two options for the CSRC to impose fine. The CSRC can impose: (1) a fine “one to five times of illegal profits”; or (2) a fine “not more than the value of securities illegally purchased or sold”. Thus, if illegal profits from insider trading is $1,000, the CSRC could impose a fine at least $1,000 in accordance with option (1); or an amount between 0 to $1,000 in accordance with option (2). In fact, the CSRC was always found to adopt a lighter standard, i.e. option (2). Wrongdoers were only fined approximately 0.1 times of their illegal profits. The Chinese Securities Law (1999) did not fine illegal insider trading without profits. This standard is too low to deter frauds. Table 9 provides a summary of administrative penalties imposed on illegal insider trading cases by the CSRC.

(Table 9) Administrative Penalties by the CSRC

<table>
<thead>
<tr>
<th>Case Number</th>
<th>Name of Case</th>
<th>Illegal Profits (RMB10,000)</th>
<th>Fine (RMB10,000)</th>
<th>B/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CSRC[1993]99</td>
<td>Huayang &amp; Longgang</td>
<td>0</td>
<td>0</td>
<td>N/A</td>
</tr>
<tr>
<td>2. CSRC[1994]13</td>
<td>Xiangfan Trust and Investment Company (Shanghai Branch)</td>
<td>1,671.2</td>
<td>50</td>
<td>0.03</td>
</tr>
<tr>
<td>3. CSRC[1998]32</td>
<td>Minyuan Hainan</td>
<td>6,651</td>
<td>20</td>
<td>0.003</td>
</tr>
<tr>
<td>4. CSRC[1998]73</td>
<td>Wang Chuan</td>
<td>61</td>
<td>10</td>
<td>0.16</td>
</tr>
<tr>
<td>5. CSRC[1999]6</td>
<td>Dai Lihui</td>
<td>67.57</td>
<td>1.5</td>
<td>0.02</td>
</tr>
<tr>
<td>6. CSRC[1999]13</td>
<td>Yu Mengwen</td>
<td>8</td>
<td>5</td>
<td>0.63</td>
</tr>
<tr>
<td>7. CSRC[1999]20</td>
<td>China Qingqi Group</td>
<td>2,805</td>
<td>50</td>
<td>0.02</td>
</tr>
</tbody>
</table>

108 The traditional Chinese view is that the law is an instrument used by the government to enforce its power and authoritative control and to maintain social order. The judicial system of China is still treated as part of the government’s administrative system.
Taken such shortcoming into consideration, the Chinese Securities Law (2006) has abolished the old standard and requires the amount of fine be at least one time of illegal profits. This rule is the same as the bottom line under the U.S. regulation. The revised law has also clarified some vague terms. Table 10 provides a comparative review of major changes brought by Chinese Securities Law (2006) with respect to insider trading administrative legal liabilities.


<table>
<thead>
<tr>
<th>Administrative Liabilities</th>
<th>Individual involved in illegal insider trading</th>
<th>Dispose of the securities that was illegally holds in accordance with law</th>
<th>Confiscate illegal profits</th>
<th>Fine</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese Securities law(1999)</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


More severe punishment to an individual who works at the securities regulatory agencies

Entity involved in illegal insider trading
- Warning to the person-in-charge and any other person as held to be directly responsible
- Fine to the person-in-charge and any other person as held to be directly responsible

B. Civil Enforcement

In the U.S., civil proceedings brought by the SEC have been proved to be a powerful tool against illegal insider trading. In 1988, the U.S. congress expressly authorized private actions for insider trading. The SEC may seek disgorgement, injunction, bar or suspend individuals from acting as corporate officers or directors, and civil penalties. With respect to insider trading, a penalty of up to 3 times the profit made or loss avoided can be imposed.

Civil penalty could be very severe. For example, in 2002, media celebrity Martha Stewart was investigated for alleged insider trading, after selling 3,928 shares of ImClone Systems on December 27, 2001. The SEC filed its complaint in June 2003, charged Martha Stewart, as well as Peter Bacanovic who illegally tipped Stewart with nonpublic information of ImClone stock. Stewart sold all of her ImClone stock before a negative announcement that the Food and Drug Administration would not review ImClone’s application for Erbitux which the company touted as a promising cancer drug. Stewart was charged disgorgement of $45,673, representing the losses avoided from her insider trading, plus prejudgment interest of $12,389, for a total of $58,062, and a civil penalty of $137,019, representing three times the amount of the losses avoided. She was also

111 See section 20A, the Exchange Act of 1934.
112 See The Washington Post (August 8, 2006), Stewart Resolves Last of Charges; $195,000 Settles Civil Complaint.
imposed a five year bar from serving as a director of a public company. Bacanovic has also been punished with the disgorgement of $510, representing the commissions he earned as a result of the Stewart’s ImClone stock sale, plus prejudgment interest of $135, for a total of $645, and a civil penalty of $75,000.\textsuperscript{113} Obviously, the combination of monetary punishment and future professional restrictions both serve to deter the illegal insider trading.

Unlike what’s found in the U.S., there is no civil enforcement on insider trading in China. Traditionally, China’s legal system places an emphasis on administrative and criminal sanctions.\textsuperscript{114} Civil enforcement in China is insufficiently developed.\textsuperscript{115} As a matter of fact, neither the CSRC nor a shareholder successfully brings a civil lawsuit against wrongdoers.

The Chinese Securities Law (1999) paid little attention to the civil liabilities for securities violations; it contains no clear provisions for recovering investors’ losses. The old law contained one vague civil remedy provision in cases of misrepresentation but it was not related to insider trading.\textsuperscript{116} Many fundamental issues remain unresolved. For example, which court has the jurisdiction to hear the case? Are there any preconditions for filing the lawsuit? Shouye Cao, a famous Chinese judge of the Supreme People’s Court (SPC) commented that “the Securities Law provides very few provisions on civil liabilities. As the provisions are not specific enough, the courts have difficulties applying them”.\textsuperscript{117}

In recent years, some initiatives on civil sanctions and remedies have been enacted but they have failed to provide civil remedies for insider trading. The lack of civil remedies for securities fraud was first challenged in a false disclosure case by Hongguang Industries in 1998.\textsuperscript{118} After that, investors filed a wave of lawsuits

\textsuperscript{113} See SEC v. Martha Stewart and Peter Bacanovi, 03 Civ. 4070 (RJH) (S.D.N.Y.)


\textsuperscript{115} See Ibid., at 3.

\textsuperscript{116} It stated: “in the event that any issuer or underwriter makes a misrepresentation, misleading statement or material omission in its prospectus, financial and accounting reports, annual reports or interim reports, and which has caused losses to investors in securities transactions, such an issuer or underwriter have an obligation to compensate the investors for the losses. The responsible director, supervisor and director in the issuer or underwriter are also jointly liable for such compensations.”

\textsuperscript{117} See Mi, Chai (2001), Securities Market Calls for Civil Compensation, 44 Beijing Review 11.

\textsuperscript{118} A shareholder brought the case to the People’s Court in Pudong District of Shanghai, demanding civil compensation. The case failed the court holding that it could not find a direct causation link between the losses of the shareholders and the false disclosure.
against a number of Chinese Enrons, such as Yinchuan Guangxia and Zhengzhou Baiwen. Chinese courts were apparently not prepared for the sudden surge in shareholders’ civil lawsuits.

The initial response from the SPC to the shareholders’ civil lawsuits was disappointed those who believe that more powerful remedies are needed to protect investors. On September 21, 2001, the SPC issued “The Circular Regarding Non-accepting or Hearing of Civil Remedy Cases in the Securities Markets” which states that “due to the weakness of the current securities civil liability system and limits on the quality of judges, the court would not accept or hear such cases for the time being”. Such an announcement shocked everyone with a stake in the market or concerned about capital markets and legal developments in China.119

On the side of Chinese regulators, they worried about jeopardizing the reputation and credibility of the whole legal system, overwhelming number of cases, inexperience judges and the loss of state assets.120 The viewpoint of the SPC began to change since January 15, 2002 when it issued “The Notice on the Issues of the Trial of Civil Damages Cases Arising from Misrepresentations in the Securities Markets.” On January 9, 2003, the SPC further issued “the Provisions Governing the Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Markets”, providing more detail instructions for the acceptance of cases and jurisdiction, procedures of bringing lawsuits, determination of misrepresentation, liabilities determination and exemption, joint tort liability and calculation of losses. However, due to various procedural and substantive hurdles


120 Firstly, as civil lawsuits were filed against the same defendant and for the same cause but by different plaintiffs and in different lower courts, it became possible that there would be different rulings, the occurrence of which would jeopardize the reputation and credibility of the whole legal system. In the history of China, there had never been such an instance in which numerous plaintiffs would simultaneously file separate lawsuits in different provinces but against the same defendants and for the exact same cause. Secondly, if financially injured investors each filed an individual lawsuit, the entire court system would be more than overwhelmed with securities litigation. Were there more efficient ways to handle such a mass litigation? Thirdly, given the lack of prior experience in this area, the lower court judges had no uniform standards yet with regard to such questions as that had a standing to sue, what type of evidence was required, and how damages were calculated. Finally, if there were numerous lawsuits against all these listed firms and if the private plaintiffs were awarded rightfully deserved relief, this would lead to major losses of state assets (because most of the listed companies in China were state controlled). In such a civil litigation, the defendant’s interest was in fact the State’s interest. This is precisely where plaintiff’s rights and the State interests collided. Was there a compromise between the two? How could there be judicial independence? These questions and reasons were sufficient to cause the court to pause. See Hutchens, Walter (2003), Private Securities Litigation in China: Material Disclosure About China's Legal System, 24 University of Pennsylvania Journal of International Economic 599
that impeded the investors’ access to judicial recourses, the real effect of these rules is disputable.\textsuperscript{121}

It is very important to develop administrative, criminal and civil sanctions equally. With the purpose to enhance market supervision, it is not efficient to rely only on the government, whose supervisory resources were limited. China’s stock markets requires more monitoring of individual investors by bringing lawsuits against irregularities, which is a useful mechanism to improve market supervision.\textsuperscript{122}

In 2006, the Chinese Securities Law (2006) established legal basis regarding civil liability for insider trading for the first time, which states: “if insider trading causes any loss to investors, the wrongdoer should be liable for damages in accordance to the law.”\textsuperscript{123} The real effect of this clause remains to see when the court applies it in a real case.\textsuperscript{124}

It is worth mentioning that the system of class action, an effective method to protect investors in the U.S., has been rejected under the Chinese Securities Law (2006). Lawmakers claim that the time is not ripe for class actions to be applied to China as such an innovation has no legal basis under the Chinese laws and the system of class action itself has many problems to be fixed.\textsuperscript{125} Commentators believe the explanation is more likely to be economic and political in nature. Class action regime may easily lead the public listed SOEs to bankruptcy because the exposure to massive litigations would hurt the state interests.

\begin{itemize}
\item \textsuperscript{121} For example, not all securities frauds have been covered under these rules. Jurisdiction requirements are unfavorable to the investors. Investors should file their lawsuits at the intermediate court in the listed company’s place of business. Investors not only need to spend high traveling costs on the lawsuit, but also bear high risks as most listed companies are well-protected by the local government.
\item \textsuperscript{122} See Wang, Liming (2001), Woguo Zhengquanfa Zhong Minshi Zeren Zhidu De Wanshan (Perfect the Civil Liability System of the Securities Regulation), 1 Zhengquan Falv Pinglun (Securities Law Review) 109.
\item \textsuperscript{123} See Article 76 of Chinese Securities Law (2006).
\item \textsuperscript{124} There are many issues to be answered by the law, such complex issues as investors who can show lost and how to determine loss are not mentioned in law.
\item \textsuperscript{125} See Stephen, J. Choi (2004), The Evidence on Securities Class Actions, 57 Vanderbilt Law Review. This article examines the theoretical issues and surveys the evidence on the desirability of securities class actions, as well as explores related problems with class actions. It also explored impact of class action system to an emerging market like Korean. Should the class action system be introduced into China, similar problems will also be found in China, such as the resource of experienced attorneys is very limited to help minority shareholders to bring class actions case, which, on the other hand, may impede these minority shareholders from executing their legal rights.
\end{itemize}
C. Criminal Enforcement

Criminal enforcement has been gradually enhanced in the U.S. The U.S. Congress enacted The Insider Trading Sanctions Act (ITSA) in 1984. Under the ITSA, there is a ten-fold increase in criminal penalties from $10,000 to $100,000. In 1988, the Insider Trading and Securities Fraud Enforcement Act was enacted, which increased the maximum terms of imprisonment from 5 to 10 years, with maximum criminal fines for individuals from $0.1 million to $1 million and for corporations from $0.5 million to $2.5 million. The Sarbanes-Oxley Act of 2002 significantly increased the criminal penalties for all forms of frauds, including insider trading. The maximum fine for individuals was increased five-fold, i.e. $5 million and the maximum penalty for corporations was increased from $2.5 million to $25 million. The maximum term of imprisonment was raised from 10 to 20 years.

With these weapons, the SEC has become notably unforgiving of insider trading violations. For example, on July 11, 2003, Samuel Waksal, former president and CEO of ImClone Systems, was sentenced for his illegal insider trading to 87 months (more than 7 years) in prison and was ordered to pay a $3 million fine and $1.26 million in restitution.\(^{126}\)

Unlike civil enforcement measures on insider trading which were just recently introduced, China has enacted its criminal rules as early as in the 1997. This again revealed the fact that Chinese legislative history primarily focused on administrative and criminal regulations.

Article 180 of Chinese Criminal Law (1997) provides that:

[insider traders] shall be sentenced to not more than five years in prison or criminal detention, provided the circumstances are serious. They shall be fined, additionally or exclusively, a sum not less than one but not more than 5 times of their illegal profits. If the circumstances are especially serious, they shall be sentenced to not less than 5 years and not more than 10 years in prison. In addition, they shall be fined a sum not less than one and not more than 5 times of their illegal proceeds.

Although the rule was introduced in the 1997, the first criminal enforcement action against insider trading was seen in 2003 in the case of Ye Huanbao and Gu Jian. This is only one criminal case with respect to insider trading in China until now. In this case, Ye was sentenced in jail for three years and Gu was sentenced in jail for two years. Each of them was fined at RMB800,000 (approximately $100,000) at one time of illegal profits. However, there is no reason to believe that there was only one criminal insider trading violation in China.

\(^{126}\) See Chicago Tribune (2003), Insider Trading Yields 7-year Term for Waksal.
Taken as a whole, criminal enforcement found in China are significantly less severe than that of the U.S.

VI. CONCLUSION

During the past 20 years, China has undergone a profound economic transformation. Its economy has gradually evolved from a planning-oriented one into a market-oriented one. Change in law has been deployed as an important tool in effectively managing their evolution. China’s stock markets and its legal regulation are one important part of that larger phenomenon.

We have already seen policy changes in China’s stock markets. On April 29, 2005, the CSRC issued “The Circular on the Pilot Reform of Share Tradability of Public Listed Companies” and embarked on the reform of non-tradable shares. According to this rule, listed companies on the pilot program should work out a plan for floating, and submit to shareholders’ meetings for approval. The CSRC aims to reduce percentage of state-owned shares which essentially make all currently non-tradable shares become tradable on the market. This rule aims to solve root problem of China’s securities regulations.

Meanwhile, China has already started a new round of fresh thinking about its securities regulation. With the issuance of Chinese Securities Law (2006), China has placed its efforts by shifting away from a merit-based regulatory system to a disclosure-based regulatory system of regulation. Disclosure-based regulatory regime is more consistent with market-based regulatory regime widely adopted in many stock markets. Merit-based regulatory regime, on the other hand, has made enforcement and compliance more costly. The CSRC is expected to benefit from this transformation to enhance its capacity and reduce intervention of operations of listed companies. With these new policies and rules, China’s stock markets are expected to grow into a more efficient market and incentives for trading on inside information may be greater with the development of public trading and takeover activities.

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127 Under the merit based system, regulators would make a judgment on the substantive merits of the application and approve only those where it deems appropriate for listing.

128 Under disclosure-based system, regulators review the registration statement, but its review is essentially to ensure that the required disclosures are in place, and when satisfied, the SEC does not approve the registration statement but merely declares it effective.

129 Article 24 of the Chinese Securities Law (2006) has deleted the word “approval” and inserted the word “ratify” with respect to the CSRC review of companies listing application.

130 In well-developed disclosure-based regulatory environments, institutional investors and self-regulatory organizations help raise the standard of market supervision. In a merit-based environment, however, market regulators must set up necessary standards and impose market discipline on the participants.
As an important part of securities regulation and supervision, Chinese regulators need to make more efforts on the enforcement of insider trading regulation. In my view, Chinese regulators should move steadily on three fronts:

(1). I suggest that Chinese regulators make efforts to detect illegal insider trading. With greater likelihood of detection there comes greater deterrence of insider trading. One basic strategy is to enhance the information disclosure mechanisms, particularly focus on timely disclosure so as to reduce insiders’ discretion over the timing of information disclosures as corporate insiders can manipulate the timing in order to trade profitably. Moreover, the enforcement budget and resources of the CSRC, in particular, the portion for insider trading enforcement should be substantially increased. Currently, it is necessary to maximize the effectiveness of available resources and ensure focusing on the combined efforts of key enforcement agencies, such as the cooperation between the CSRC and stock exchanges and the CSRC and the prosecutors.

(2). I suggest that Chinese regulators enhance the sanctions to be imposed on detected illegal insider trading. First, penalties should be increased. The current amount of penalty is too low to punish wrongdoers. Where the penalties imposed for noncompliance or the chances to be caught are low, insiders have little incentive to comply with the law. Second, from the deterrence perspective, the CSRC should be empowered to bring civil actions. Civil remedies should be enhanced so as to provide incentives for investors to detect and assist in the apprehension and prosecution of violators. Thus, it will supplement the under-funded enforcement activities of the CSRC.

(3). It is always good to give consideration to what are considered to be international best practice, even if they may require adjustment in light of material conditions. The U.S. law will continue to exert its influence on the development of China’s insider trading regulations. Recently, the SEC and the CSRC has signed a memorandum in which the regulators will embark on a comprehensive technical assistance and training program and the SEC will share its experiences and knowledge related to investigation and enforcement of securities law violations. Of course, it is not practical fully to import U.S. rules and practice in China. No “one-size-fits-all” in legal systems and in enforcement. Regulation and enforcement vary between the U.S. and China with different legal traditions, i.e. the U.S. in a common law country and China is civil law country. What’s more, differences also arise from local capital market conditions, such as financial resources, human resource, and culture and so on. Hence, China should adhere to an approach compatible to its culture and has to consider the costs and efficiencies implicated. Due to unsophisticated nature of China’s emerging

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markets and the inexperienced market participants, I suggest a “stable growth” approach by more on enforcement and “good and better regulation” instead of “more regulations but poor enforcement”.