The regulation of insider trading in China: A critical review and proposals for reform

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The purpose of this article is to critically examine Chinas insider trading regulation, and based upon the results of such examination, set out reform proposals for China. With the benefit of overseas experience, in a relatively short period of time, China has made a remarkable achievement in setting up its insider trading regulatory regime. There are, however, some serious problems with the Chinese law, due to the uncritical implantation of the ideas from foreign sources. This is strikingly illustrated by the loopholes in the definition of insiders which are inherently related to the confusion around the underlying theory of insider trading liability. The article first broadly describes the background of the regulation of insider trading in China, and then offers a detailed discussion of its content. Based on this, a critique of Chinas insider trading regulation is carried out. It appears that China has hastily imported two conflicting insider trading theories, namely the equality of access theory and the fiduciary-duty-based theories which include the classical theory and the misappropriation theory. A careful analysis suggests that the equality of access theory is preferable to the fiduciary-duty-based theories, especially in the context of China. It is further submitted that the Australian information connection only approach to the definition of insiders is both theoretically justifiable and practically manageable, and thus should be introduced to reform Chinas insider trading regulation.

Introduction

The purpose of this article is to critically examine China's insider trading regulation and, based upon this examination, set out reform proposals for China. Insider trading has been deemed harmful to market fairness and efficiency in China, with the Chinese government regulating insider trading at almost the same time the stock market was established. With the benefit of overseas experience, in a relatively short period of time, China has made a remarkable achievement in setting up its insider trading regulatory regime. It appears, however, that in some respects, China has been too ready to import ideas from foreign sources, without adequately assimilating them into its local situation. This has resulted in serious problems, which have significantly affected the efficacy of the Chinese law of insider trading.

The article is organised as follows. Part I will first broadly describe the background of the regulation of insider trading in China. The underlying

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securities market, the legislative history and the extent of insider trading will be reviewed here. A detailed discussion of China's insider trading regulation will follow in Part II. This will provide a basic ground for a critique of Chinese insider trading law which is the subject of Part III. Part IV will carry out an in-depth comparative analysis of the theories of insider trading liability and the varying approaches to the definition of insider, with a view towards solving the problems with the current Chinese law. Part V will make a concluding remark.

I The background of insider trading regulation in China

A An overview of China's securities market and its regulatory regime

In comparison to most western countries, China's modern financial market is very young, born in the 1980s under the 'reform and opening up' policy of the Communist Party to meet the needs of the rapidly growing economy. It should be noted that the bond market developed before the stock market because the former was more readily ideologically accepted by the Communist Party at the outset of reform. In 1981, a bond market was established, signifying the birth of the present-day financial market. However, the bond market only met the liquidity needs of the government, leaving unaddressed the urgent capital needs of many private enterprises.[1]

Recognising the financial difficulty private enterprises and state-owned enterprises were faced with, the government responded with the development of the stock market.[2] The establishment of the two stock exchanges in Shanghai and Shenzhen in the early 1990s marked a new stage in China's securities market.[3] Even though China's securities market has a quite short history, it has made remarkable progress so far and played an increasingly important role in China's economic development. There has been a rapid growth of the stock market since 1990. By the end of 2003, the two stock exchanges were handling an aggregate of 1287 listed companies with a market capitalisation of RMB4.24 trillion (roughly US$531 billion or AU$849 billion).[4] Thus, in terms of market capitalisation, China's stock market is now comparable with its Australian counterpart which had a total

1 Wei Zhang and Chu Li, *Zhongguo Zhaiwu Wenti Yanjiu [Research on the Questions of China's Debts]* 1st ed, China Finance Publishing House, 1995, p 42.

2 Hong Wu et al, *Zhongguo Zhengquan Shichang Fazhan de Falu Tiaokong [Legal Adjustment of the Development of China's Securities Market]*, 1st ed, Law Press, 2001, p 8; see also I A Tokley and T Ravn, *Company and Securities Law in China*, 1st ed, Thomson Professional Publishing Cn, 1998, p 63.

3 The Shanghai Stock Exchange was established in December 1990 and the Shenzhen Stock Exchange in July 1991. Both of them are nationwide stock exchanges, and non-profit, self-disciplined membership institutions and legal persons.

4 See the official website of the China Securities Regulatory Commission: <http://www.csrc.gov.cn/en/statinfo/index1_en.jsp?path=ROOTENStatistical%20 InformationIssuing> (Summary of Raising Capital for Securities Market) (accessed 17 June 2004).

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market capitalisation of AU$772 billion as of the end of 2003.[5]

In accordance with the step-by-step development of the underlying stock market, China's regulatory regime has evolved over time, from a number of dispersed regional regulators to a highly centralised national regulator. Before October 1992, the regulatory regime was made up of a group of provincial regulatory bodies which operated relatively independently of each other under the directions of respective local governments.[6] In October 1992, the central government established the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC), marking the beginning of the uniformity of the national securities regulatory system. Under this scheme, the SCSC was the national authority responsible for the regulation of the securities market, and the CSRC was the SCSC's executive branch which was charged with supervisory responsibility over the securities market nationwide in accordance with law.

Finally, in April 1998, due to the growing influence of the CSRC in the securities regulation, the State Council merged the SCSC (the former boss of the CSRC) into the CSRC in resolution of the conflict of powers between them. Consequently, the CSRC was upgraded as a ministry rank unit directly under the leadership of the central government and as a consequence, both the powers and functions of the CSRC were further strengthened. After this overhaul of the regulatory regime, a centralised regulatory regime was finalised and the CSRC has been exclusively responsible for securities regulation in China.[7]

B The development and features of China's insider trading regulation

The history of the regulation of insider trading in China can be traced back as early as 1990 when the stock market was at its very early stage. The term 'insider trading' (*Neimu Jiaoyi*) was first seen in the Provisional Measures for Regulating Securities Companies (1990).[8] However, since this regulation did not contain functional provisions concerning insider trading, it was largely of symbolic value and more like a political announcement than a real law.

In April 1993, the State Council released the very powerful Provisional Regulations on the Administration of Stock Issuance and Trading (Provisional Regulations).[9] This regulation contained a number of important provisions regarding insider trading, but had no detailed provisions in respect to the

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5 See the website of the Australian Stock Exchange: <http://www.asx.com.au/statistics/l3/HistoricalEquityData_MS3.shtm#End_of_month_values> (accessed on 17 June 2004).

6 See, eg, Jinxuan Bao, 'Improve the Securities Regulatory and Self-regulatory Regime in China' (1999) 3 *Fashang Yanju [Study on Law and Commerce]* 66.

7 See the website of the CSRC: <http://www.csrc.gov.cn/csrcsite/eng/eabout/eintr.htm> (accessed 16 June 2004); also Hong Wu et al, *Zhongguo Zhengquan Shichang Fazhan de Falu Tiaokong [Legal Adjustment of the Development of China's Securities Market]*, above n 1, pp 9–10.

8 Zhenquan Gongsi Guanli Zanxing Banfa [Provisional Measures for Regulating Securities Companies], Promulgated in October 1990, PRC.

9 Gupiao Faxing yu Jiaoyi Guanli Zanxing Tiaoli [Provisional Regulations on the Administration of Stock Issuance and Trading], 22 April 1993, PRC (Provisional Regulations).

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definitions of insider and inside information. Shortly afterwards, in September 1993, the CSRC promulgated the Provisional Measures for the Prohibition of Securities Fraud (Provisional Measures).[10] This regulation was specifically designed to address various types of fraudulent misconduct in the stock market, including insider trading. A set of very clear, detailed provisions were devoted to insider trading. In October 1997, the National People's Congress (NPC) revised the Criminal Law of the People's Republic of China (Criminal Law)[11] to include insider trading. It should be noted that the Criminal Law does not define insider trading, but instead makes reference to other laws and regulations with respect to insider trading.

The period between 1996 and 1998 witnessed a considerable amount of fraudulent misconduct in the stock market, including misrepresentation, market manipulation, insider trading, and misappropriation by securities companies of clients' funds.[12] The perception that the existing government regulations were failing to meet regulatory needs led to the establishment of a national securities law. The well-known 1997 Asian financial crisis was also regarded as influencing this lawmaking process.[13]

In July 1999, the long-awaited Securities Law of the People's Republic of China (Securities Law) came into effect.[14] This was a major milestone for securities regulation in China. The Securities Law paid a fair amount of attention to insider trading, devoting as many as five articles to it.[15] While this insider trading regime was not without problems, it paved the way for the regulation of insider trading in a rule-of-law based manner in China.

As discussed above, although China's securities legislative history is quite short, China has made a noticeable achievement in setting up its insider trading regime. It is worth noting some important features in China's insider trading law. The first is that the government has shown a great willingness to regulate insider trading. The regulation of insider trading in China was born at the very early stage of the stock market with little opposition to the idea that insider trading should be prohibited. In this respect, China contrasts sharply with other jurisdictions where the question of whether to outlaw insider trading has been greatly debated. For instance, Japan had no insider trading provisions until 1988 when it amended its securities exchange law.[16] In the

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10 Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa [Provisional Measures for the Prohibition of Securities Fraud], 2 September 1993, PRC (Provisional Measures).

11 Zhonghua Renming Gongheguo Xingfa [Criminal Law of the People's Republic of China], October 1997, PRC (Criminal Law).

12 Hong Wu et al, *Zhongguo Zhengquan Shichang Fazhan de Falu Tiaokong [Legal Adjustment of the Development of China's Securities Market]*, above n 1, p 12.

13 R Tomasic and J Fu, 'The Securities Law of the People's Republic of China: An Overview' (1999) 10 *Aust Jnl of Corp Law* 268 at 269. However, some commentators thought that the outbreak of the 1997 Asian financial crisis frightened the Chinese government which became more cautious about the stock market and thus retarded the process of the lawmaking. See Wu Hong et al, *Zhongguo Zhengquan Shichang Fazhan de Falu Tiaokong [Legal Control on the Development of China's Securities Market]*, above n 1, p 18.

14 Zhonghua Renming Gongheguo Zhengquanfa [Securities Law of the People's Republic of China], 1 July 1999, PRC (Securities Law).

15 These Articles will be critically examined in detail in the following parts.

16 See, eg, T Akashi, Note, 'Regulation of Insider Trading in Japan' (1989) 89 *Colum L Rev* 1296 at 1298–9 (stating that the Japanese authorities lacked enthusiasm to regulate insider trading); F A Gevurtz, 'The Globalization of Insider trading Prohibitions' (2002) 15

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United Kingdom, it was not until 1980 that insider trading was criminalised, despite the UK stock market being in existence since the last quarter of the seventeenth century.[17]

The other feature of China's insider trading law is its use of overseas experience. China's insider trading law has benefited greatly from valuable overseas experience, particularly from the United States. Indeed, the drafting of the Securities Law received direct assistance from the United States.[18] The advanced overseas experience provided China with a good starting point to enact its securities regulations. Learning from foreign experience has enabled China to significantly reduce its legislative costs and thus facilitate the enactment of insider trading law. This may explain why China has established its insider trading regime in such a short period of time. With the benefits of overseas experience, China's insider trading regime has become more concrete and workable since insider trading was initially prohibited in 1990.

However, borrowing from the overseas experience has still led to some problems. It appears that China has been too ready to import foreign experience. Indeed, the Chinese government has come to believe that any successful development of China's securities market would only be possible if China was equipped with laws and regulations comparable to those in place in developed countries. This has adversely affected the legislative process so as to preclude a sufficiently careful reflection on the necessity, coverage, and implications of the legislation in China. For this reason, in practice, China's insider trading regime is far from effective.[19] Thus far, there have been a very small number of reported insider trading cases in China.[20]

C The extent of insider trading in China

Insider trading appears to be a very serious problem in China. Many commentators have thought that insider trading is widespread,[21] with one stating that:

Transnational Lawyer 63 at 85 (maintaining that the Japanese government 'was not sure how much it really wanted to enact an insider trading prohibition').

17 G Brazier, *Insider Trading: Law and Regulation*, Cavendish Publishing Ltd, 1996, pp 90–5.

18 M Gu and R C Art, 'Securitization of State Ownership: Chinese Securities Law' (1996) 18 *Mich J Int'l L* 115 at 117.

19 See, eg, Chunfeng Wang et al, 'Insider Trading and the Regulation on China's Stock Market: International Experience and China's Response' (2003) 3 *Guoji Jingrong Yanjiu [International Finance Research]* 57 at 63 (stating that China's insider trading regulation needs to be improved); Donghui Shi and Hao Fu, 'The Regulation of Insider Trading in China: A Legal and Economic Study', paper presented at the Symposium on 'Behavioral Finance and Capital Market', Nanjing, China, 29–30 November 2003, p 36 (positing that 'China's insider trading regulation is not effective').

20 Shunyan Zhen, *Zhengquan Neimu Jiaoyi Guizhi de Bentuhua Yanjiu [Localized Study on Securities Insider Trading Regulation]*, 1st ed, Peking University Press, 2002, pp 58–65.

21 See, eg, Huaren Liang et al, 'An Analysis on Insider Trading' (2001) 5 *Faxue Zazhi [Law Science Magazine]* 9 at 13 (stating that 'insider trading has been widespread in China's stock market and has severely damaged the market development'); Gaocheng Wu et al, 'Introducing the Civil Liability of Insider Trading' (2003) 2 *Dangdai Faxue [Modern Law Science]* 89 at 89 (positing that 'insider trading is serious in China's stock market and investors protection needs to be enhanced').

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> In the [Chinese] stock market, about 80 percent of all securities cases are connected with insider trading, and about 80 percent of the amount of money in all securities cases are connected with inside trading.[22]

This view has been backed by empirical works which indirectly examine the incidence of insider trading in China. A recent empirical study selected a sample of all the listed companies on the Shanghai Stock Exchange between 2000 and 2001, and investigated the effects of the disclosure of four kinds of material information, namely substantial investment projects, rights issuance, corporate control transfer, and the substantial increase in earnings in the annual report.[23] The study showed that the figures of the Cumulative Abnormal Return (CAR) increased remarkably in the period 20 days before information disclosure and decreased sharply thereafter. In regards to the rate of changeover of shares, similar situations appeared; the rate was 1.125% before the disclosure and 0.334% after.[24] Another indicator, the figure of volatility, also experienced the same change. It was concluded that the information at issue might have leaked out before its disclosure and massive insider trading might have occurred to create the abnormal changes in those financial variables.[25]

II The content of China's insider trading regulation

As discussed before, the Chinese insider trading law is heavily influenced by the US experience. In general, China's insider trading law centres upon primary insider trading situations, and extends liability to those who trade on the basis of misappropriated information. Aside from trading, tipping and procuring are also prohibited. Further, the Chinese legislation includes a short-swing trading prohibition.

A The overall framework and the notion of insider

Article 67 of the Securities Law generally prohibits persons with knowledge of inside information on securities trading from using such inside information to trade securities.[26] This broad net, however, is restricted by other articles. Article 68 lists some specific types of persons which are considered to be 'persons with knowledge of inside information'. They include:

1. Directors, supervisors, managers, deputy managers and other senior management persons concerned of companies that issue shares or corporate bonds;
2. Shareholders who hold not less than 5 percent of the shares in a company;
3. The senior management persons of the holding company of a company that issues shares;

22 See preface by Professor Zhipan Wu in Shunyan Zhen, *Zhengquan Shichang Budang Xingwei de Falu Shizheng [Legal Analysis on Misconduct on the Securities Market]*, 1st ed, University of Law & Politics Press, 2000.

23 Chunfeng Wang et al, 'Insider Trading and the Regulation on China's Stock Market: International Experience and China's Response' (2003) 3 *Guoji Jingrong Yanjiu [International Finance Research]* 57.

24 Ibid, at 59.

25 Ibid, at 61.

26 Securities Law Art 67.

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4. Persons who are able to obtain material company information concerning the trading of its securities by virtue of the positions they hold in the company;
5. Staff members of the securities regulatory authority, and other persons who administer securities trading pursuant to their statutory duties;
6. The relevant staff members of public intermediary organizations who participate in securities trading pursuant to their statutory duties and the relevant staff members of securities registration and clearing institutions and securities trading service organizations; and
7. Other persons specified by the securities regulatory authority under the State Council.[27]

According to this list, statutory insiders can be categorised into several groups. The first group is corporate directors and officers, including directors, supervisors, managers, deputy mangers and other senior management persons of the corporation[28] and its holding corporation.[29] Secondly, apart from the members of senior management, lower-level employees are also deemed insiders if they have obtained inside information in connection with their employment.[30] This category may represent the largest number of insiders. Thirdly, substantial shareholders are also insiders for the purpose of insider trading law.[31] In China, a shareholder with 5% or more of the shares issued by a listed company is considered to be a substantial shareholder and thus subject to certain obligations, such as the shareholding reporting requirement[32] and the prohibition of short-swing trading.[33]

The above three groups are all traditional corporate insiders, but the insider trading prohibition is not limited to them. There are two more groups of persons who are nominal outsiders but nevertheless subject to the prohibition. One group are so called temporary or constructive insiders, namely a variety of nominal outsiders who participate in securities trading pursuant to their statutory duties or private contracts, such as underwriters, accountants, lawyers, consultants and the staff members of securities registration and clearing institutions.[34] The other group are regulatory officials, namely persons who have regulatory authority over securities trading.[35]

Apart from the above primary insider trading instances, the Chinese law also reaches cases where the misappropriation theory is the only basis for finding a violation.[36] Under Art 70, a person who has illegally obtained material non-public information has an insider's duty and thus is prohibited from trading on the basis of the information.[37]

Further, the circumstances where an insider may violate the insider trading law are set out in order to secure greater efficacy of the prohibition. Under Art 70, the prohibited conduct by persons in possession of inside information

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27 Securities Law Art 68.
28 Securities Law Art 68(1).
29 Securities Law Art 68(3).
30 Securities Law Art 68(4).
31 Securities Law Art 68(2).
32 Securities Law Arts 41 and 79.
33 Securities Law Art 42.
34 Securities Law Art 68(6).
35 Securities Law Art 68(5).
36 For discussion of the misappropriation theory, see Pt IV(A)(2).
37 Securities Law Art 70.

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includes not only trading, but also tipping and procurement.[38] Firstly, a person is prohibited from trading affected securities if he or she possesses material non-public information acquired as an insider (the trading prohibition). This applies no matter whether the insider is a buyer or a seller of securities. Secondly, it is prohibited for an insider to divulge to third parties the information in his or her possession (the tipping prohibition). Finally, insiders are prohibited from procuring another person to trade securities, when such procurement is based on material non-public information in their possession (the procurement prohibition).

By the tipping and procurement prohibitions, the insider trading law can effectively avoid easy circumventions. In these two instances, according to Art 70, it is not essential that there be trading for liability to attach.[39] Put another way, the insider will be held liable for merely tipping the information or procuring the transaction, even if there has been no transaction. Hence, whether or not the tippee or the person procured to trade actually trades is irrelevant to the liability of the insider. In contrast, under US law, a tipper is not subject to r 10b-5 liability if no trading takes place, because any violation of r 10b-5 must be 'in connection with the purchase or sale of securities'.[40] The theory behind this is that no harm is done to the market if there is no trading, and that communication of material non-public information is beneficial to market efficiency. China's legislators, however, might have tended to believe that the irrelevance of trading in the tipping and procuring contexts could prophylactically discourage tipping and procuring activities which may potentially lead to actual trading.

B. Some basic issues

1 Inside information

Article 69(1) of the Securities Law generally defines what constitutes 'inside information' in China, providing that:

> Inside information is information that is not made public because, in the course of securities trading, it concerns the company's business or financial affairs or may have a major effect on the market price of the company's securities.[41]

However, this broad standard may be too vague and indeterminate, making it potentially very difficult to resolve litigation, and for insiders to decide whether they must disclose information before trading. In order to give some guidance and facilitate its application, Art 69(2) itemises some specific types of facts that are regarded as inside information:

1. the major events listed in the second paragraph of Article 62 of this law;
2. company plans concerning distribution of dividends or increase of registered capital;
3. major changes in the company's equity structure;
4. major changes in security for the company's debts;

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38 Securities Law Art 70.
39 Securities Law Art 70.
40 15 USC § 78j(b) (2001). For a discussion of this issue, see, eg, W K S Wang and M I Steinberg, *Insider Trading*, 1st ed, Little Brown & Co, 1996, §4.4.5.
41 Securities Law Art 69(1).

5. any single mortgage, sale or write-off of a major asset used in the business of the company that exceeds thirty percent of the asset concerned;
6. potential liability for major damages to be assumed in accordance with law as a result of an act committed by a company's director(s), supervisor(s), manager(s), deputy manager(s) or other senior management person(s);
7. plans concerning the takeover of listed companies;
8. other important information determined by the securities regulatory authority under the State Council to have a significant effect on the trading prices of securities.[42]

As the first item states, the 'major events' listed in Art 62 also fall within the scope of inside information. Under the regime of continuous information disclosure, Art 62 contains a laundry list of 'major events' that a company is obligated to disclose, by submitting an ad hoc report on those events to the CSRC and to the stock exchange where it is listed. The 'major events' under this article include:

1. a major change in the company's business guidelines or scope of business;
2. a decision made by the company concerning a major investment or major assent purchase;
3. conclusion by the company of an important contract which may have an important effect on the company's assets, liabilities, rights, interests or business results;
4. incurrence by the company of a major debt or default on an overdue major debt;
5. incurrence by the company of a major deficit or incurrence of a major loss exceeding ten percent of the company's net assets;
6. a major change in the external production or business conditions of the company;
7. a change in the chairman of the board of direction, or not less than one-third of the directors or the manager of the company;
8. a considerable change in the holdings of shareholders who each hold not less than five percent of the company's shares;
9. a decision made by the company to reduce its registered capital, to merge, to divide, to dissolve, or to file for bankruptcy;
10. major litigation involving the company, or lawful cancellation by a court of a resolution adopted by the shareholders' general meeting or the board of directors;
11. other events specified in laws or administrative regulations.[43]

As suggested by Arts 62 and 69, inside information is any material, non-public information, no matter whether it is derived from within the company whose securities are traded. Put another way, inside information includes both 'corporate information' which is internally generated by the issuer of the subject security, and 'market information' which is externally generated but nevertheless has a major effect on the stock price of the issuer.

Moreover, it appears that the definition of inside information is not confined to information that specifically relates to one or more companies or securities. A literal reading of Art 69 implies that any confidential price-sensitive information would be deemed inside information, regardless of whether it is related to securities specifically or generally. This should be immediately

42 Securities Law Art 69(2).
43 Securities Law Art 62.

relevant to the status of government policies which always have a general market application, affecting all or at least a whole sector of companies or securities in the market. If one such government policy, for example, a change in the interest rate, has a major effect on the price of the affected securities, it would constitute inside information in China. This treatment is very important in China where government policies are fast-changing and frequently abused by those with privileged access to make money in the market.

Finally, there is a specific exemption for research and analysis that take the form of deductions, conclusions or inferences made or drawn from generally available information.[44] True, market research and analysis are fundamental to ensuring an efficient market.[45] However, market research and analysis could technically constitute inside information before public disclosure because they may cause a major price movement in affected securities, especially when the analyst is influential. This would prohibit the use or communication of research results, which is clearly inconsistent with the business reality. In order to deal with this problem, market research and analysis would be treated as public if they are based on publicly available information, and therefore fall outside the scope of inside information.

2 Subjective elements

In China, the Criminal Law generally circumscribes criminal liability by requiring the perpetrator's scienter as to the existence of the facts and intentionality to engage in the illegal behaviour.[46] Insider trading liability is no exception.[47] In principle, scienter may include actual intent and recklessness, demanding that 'the crime is constituted as a result of clear knowledge that one's own act will cause socially harmful consequences, and of hope for or indifference to the occurrence of those consequences'.[48]

It is hardly surprising that for the purpose of insider trading liability, the precondition for those to be considered as insiders is that they actually possess inside information. In China, the statutory phrase of 'persons with knowledge of inside information' (*Zhixi Neimu Xinxi de Zhiqing Renyuan*) suggests that possession of inside information is required for insider trading liability to attach.[49] Further, for insider trading liability to occur, a necessary element is the defendant's knowledge of the nature of the information, more accurately, the knowledge that the possessed information is material and non-public. In China, there are two tests for proving the defendant's knowledge that the information is inside information, namely, the subjective knowledge test to prove the insider 'knew', and the objective knowledge test to prove that the

44 Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa [Provisional Measures for the Prohibition of Securities Fraud], 2 September 1993, PRC, Art 5.

45 For a theoretical discussion of the role of the investment analyst, see D R Fischel, 'Insider Trading and Investment Analyst: An Economic Analysis of *Dirks v Securities and Exchange Commission*' (1984) 13 *Hofstra L Rev* 127.

46 Criminal Law Art 14. The Criminal Law distinguishes between intentional crimes and negligent crimes. Criminal liability is to be imposed for negligent crimes only when the law explicitly stipulates. Ibid, Art 15.

47 Ibid, Art 180.

48 Ibid, Art 14.

49 Securities Law Art 67.

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insider 'ought to have reasonably known'.[50]

As discussed above, the scienter requirement demands that insiders possess inside information for liability to attach. This is followed by the question of whether *mere possession* of inside information at the time of trading is sufficient for one to invite liability, or more specifically, whether the imposition of liability presupposes a further showing that the insider actually *used* the information. In other words, is it required to prove a causal connection between the possessed inside information and the defendant's trading? This issue is well known as the 'possession versus use' debate in the United States.[51]

This issue is largely ignored in China because in most cases, there is no question that the insider traded in order to take advantage of material non-public information. However, there are some situations in which the distinction might be very important for the outcome of the cases. For example, if actual use of inside information is required for liability to attach, then one can be free to trade following a pre-existing plan, regardless of any inside information he or she may have. In contrast, if mere possession of inside information is a sufficient basis for asserting liability, it would be no excuse for the person to trade. This may potentially prevent companies from buying-back their own shares if, as is the typical case in practice, the company comes into possession of inside information when doing that. As such, the issue deserves careful attention, particularly given the stiff liability of insider trading.

In the United States, the Securities Exchange Commission (SEC) promulgated r 10b5-1 to solve this problem, providing a number of affirmative defences under which a person could avoid liability.[52] These defences permit persons to structure securities trading plans and the like, which may be implemented at any future time, provided that those persons are not aware of material non-public information at the time of devising the plans, and have no discretion over the previously determined trading plan if they later become aware of any inside information.[53] This approach strikes a good balance between the prohibition of insider trading and commercial needs, and thus can be referenced to help solve relevant problems in China.

3 Legal liability

In China, there are generally three types of legal liabilities, namely administrative liability, civil liability and criminal liability. However, as to insider trading, only administrative and criminal liability are available at the moment. According to Art 183 of the Securities Law, in the case of insider trading, administrative lability could be imposed:

50 Ibid.

51 See, eg, D M Nagy, 'The "Possession vs Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden' (1999) 67 *U Cin L Rev* 1129; J L Neumann, 'Insider Trading: Does "Aware" Really Resolve the "Possession" Versus "Use" Debate?' (2001) 7 *Washington Uni Jnl of Law & Policy* 189; A Horwich, 'Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?' (1997) 52 *Bus Law* 1235; K Schoen, 'Insider Trading: The "Possession versus Use" Debate' (1999) 148 *Uni of Pennsylvania L Rev* 239.

52 17 CFR § 240.10b5-1 (2000).

53 17 CFR § 240.10b5-1(c).

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> [insider trader] shall be ordered to dispose of the illegally obtained securities according to law, his illegal gains shall be confiscated and, in addition, he shall be imposed a fine of not less than the amount of but not more than five times the illegal gains, or a fine of not more than the value of the securities illegally purchased or sold.[54]

Article 183 also provides that if an insider trading case is serious enough to constitute a crime, criminal liability shall be pursued.[55] Criminal liability is set out in detail in Art 180 of the Criminal Law which states:

> [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 100 percent and not more than 500 percent as high as their illegal proceeds. If the circumstances are especially serious, they shall be sentenced to not less than five years and not more than 10 years in prison. In addition, they shall be fined a sum not less than 100 percent and not more than 500 percent as high as their illegal proceeds.[56]

Under the Securities Law, nothing has been said about private civil liability for insider trading except a simple provision which generally prioritises private civil liabilities for all securities violations. Article 207 of the Securities Law reads:

> If the property of a person, who violates the provisions of this Law and who therefore bears civil liability for damages and is required to pay a fine, is insufficient to pay both the damages and the fine, such person shall first bear the civil liability for damages.[57]

However, the Securities Law does not devote any specific provisions to civil damages payable to the aggrieved party by a person who has engaged in insider trading. No provisions in the Securities Law expressly address the issues concerning civil remedies, such as the standing of the plaintiff and measure of damages, rendering private civil liabilities virtually unavailable in practice and thus making Art 207 illusory. To be sure, a private right of action could be theoretically based on the existing general contract law or on the tort regime. However, due to the special nature of insider trading such as the impersonality and anonymity of exchange transactions, it is extremely difficult, if not impossible, in terms of causation and reliance, to assert insiders' liability on those conventional grounds.

C The short-swing trading prohibition

In addition to the ordinary insider trading prohibition, Art 42 of the Securities Law, modelled after s 16(b) of the US 1934 Securities and Exchange Act,[58] prohibits so-called short-swing trading. Specifically, it requires a substantial shareholder of a corporation (a shareholder holding five percent or more of the outstanding shares) to disgorge to the corporation any short-swing profits,

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54 Securities Law Art 183.
55 Securities Law Art 183.
56 Criminal Law Art 180.
57 Securities Law Art 207.
58 15 USC § 78p(b) (1994).

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namely profits made from any purchase and sale (or sale and purchase) of the corporation's equity securities in any six month period.[59]

At first glance, the short-swing trading prohibition in China appears different from its US counterpart in that corporate directors and other senior officers are not prescribed in Art 42. Upon a closer examination of the whole corporate law system in China, this is not the case. In fact, the reason why corporate directors and other senior officers are not included in Art 42 of the Securities Law lies in Art 147 of the Company Law which provides that:

> Directors, supervisors and managers shall declare their numbers of shares held by them to the company, and shall not transfer such shares during their term of office.[60]

Thus, in China, directors and senior officers are strictly prohibited from selling their company shares during their term in office. Although this prohibition may help to align the interests of management with the interests of shareholders and encourage managers to focus on the long-term growth of the company, it seems to have gone too far.[61] Yet detailed examination of this issue is well beyond the scope of this article. It is clear, however, that in light of this blanket ban on directors and other senior officers, it is not necessary to list them under the short-swing trading prohibition.

After a short-swing trading violation is detected, the board of directors of the affected company can make a claim on the profit. If the board fails to take any steps to recover the short-swing profit from the insider, the shareholders of the company have the right to require the board to do so.[62] Where the board causes losses to the corporation as a result of its failure to recover the short-swing profit, the directors responsible would bear joint and several liability for the losses.[63] To date, there has been one short-swing case in China.[64]

III A critique of the regulation of insider trading in China

A Serious loopholes in the definition of insider

As discussed earlier, China's insider trading law has adopted a closed-ended definition of 'insiders' by specifically listing certain people that are deemed to be insiders for the purposes of insider trading regulation.[65] Further, apart from the possession of relevant inside information, China has set up an additional

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59 Securities Law Art 42(1).
60 Company Law Art 147.
61 This draconian prohibition has been intensely criticised by legal scholars in China. See, eg, Liang Yang, *Neimu Jiaoyi Lun [Insider Trading]*, 1st ed, Peking University Press, 2001, p 241 (arguing that the prohibition unreasonably deprives corporate directors and other senior officers of legal rights to freely trade shares).
62 Securities Law Art 42(2).
63 Securities Law Art 42(3).
64 Decision of the China Securities Regulatory Commission on the punishment of the Shanghai Subsidiary Company of Shenzhen Baoan Group Company, the Baoan Huayang Health Care Production Company, and the Shenzhen Ronggang Baoling Electrical Lighting Company for breaching the securities regulations, 25 October 1993 (1993) 4 *China Securities Regulatory Commission Official Bulletin*.
65 There is a delegation clause in Art 68 which tries to provide some flexibility by empowering

'person connection' test to define insiders, requiring that there must be a causal link between the insider's position and the acquisition of the information. Those 'persons with knowledge of inside information' would therefore be prohibited from trading only if they have access to the information by virtue of their connection with the company whose securities are affected,[66] by virtue of their office[67] or profession.[68]

While this approach would carry the advantage of providing some bright-line rules, it has its costs. Firstly, the 'person connection' test can be difficult to apply in practice and thus unduly complicates an already complex area. As one commentator observed with regard to the EU Insider Trading Directive which also contains such a test to define insiders:

> One may consider the case of an employee who has no access to inside information in the exercise of his job but hears by chance during his working time an item of inside information. Shall he be considered a primary insider? The answer is unclear. Apparently, he does not have access to the information by virtue of the exercise of his employment, since he did not receive the information in order to perform a particular task. On the other hand, one could argue that had he not been in the office he would have never got the information and that in this sense he had access to it by virtue of the exercise of his employment.[69]

Hence, the 'person connection' test is so uncertain that it could produce conflicting outcomes.

The second problem is that defining insiders by means of enumeration could potentially be narrowing, thereby inviting loopholes in an unintended manner. Indeed, many persons who possess inside information may circumvent the prohibition and trade affected securities with impunity. The following three types of persons are illustrative of this problem.

To begin with, under Art 68, it seems that corporate directors or officers would not be viewed as insiders after they resigned from the company. This may potentially leave a loophole in the law, since resigned officers may still hold some inside information and take advantage of it. By contrast, in the United States directors or officers who resign from a corporation and subsequently trade stock will still have an insider's duty, unless it can be established that these transactions were not made while they were still in possession of material non-public information.[70] Put another way, as long as they possess material non-public information, retired corporate directors and

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the CSRC to specify other persons as insiders. See Securities Law Art 68(7). None the less, in practice, the CSRC has failed to effectively use its interpretive power to fulfil the legislative purpose. See, eg, C Z Qu, 'An outsider's view on China's insider trading law' (2001) 10 *Pacific Rim Law and Policy Jnl* 327 at 342 (stating that 'the CSRC seldom exercises its discretion to broaden the definition of "insider"').

66 Securities Law Arts 68(1) (directors and officers of the issuing company), 68(2) (substantial shareholders), 68(3) (senior officers of the holding company of the issuing company), 68(2) (corporate employees).

67 Securities Law Art 68(5) (regulatory officials).

68 Securities Law Art 68(6) (market professionals and intermediaries).

69 C Estevan-Quesada, 'The Implementation of the European Insider Trading Directive' (1999) 10 *European Business L Rev* 492 at 494.

70 L Loss and J Seligman, *Securities Regulation*, 3rd ed, Vol 8, 1st ed, Little Brown & Co, 1989, p 3587. For case law in this area, see, eg, *Polin v Conductron Corp* 552 F 2d 797

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officers are still under an insider's duty, regardless of how long it has been after their resignations.

Secondly, Art 68 only identifies regulatory officials as insiders, and other governmental officials seem to fall outside the definition. This distinction makes little sense because other governmental officials may also have privileged access to material non-public information by virtue of their advantageous position. This is especially so in China where the market is heavily influenced by government policies and thus more governmental officials are likely to commit insider trading on the basis of these policies.

Several US cases have demonstrated that apart from market regulatory officials, other government officials may also commit insider trading. In the first case, an official of the Federal Reserve Board tipped another person about impending interest rate changes and then the tippee traded on the information.[71] The second case involved a former consultant to the Navy Department who bought depository receipts of a defence contractor, knowing that the Navy was about to award it a large naval airship contract.[72] In the third case, *United States v Bryan*,[73] the defendant was a former director of the West Virginia Lottery. On the basis of confidential information entrusted to him in his official capacity, Bryan purchased the stock of companies that were slated to receive contracts from the Lottery Commission.[74]

Thirdly and most importantly, China's insider trading law is silent on the issue of tippee liability. As discussed before, Art 70 of the Securities Law prohibits an insider as prescribed in Art 68 and any 'other person who has illegally obtained inside information' from communicating the information to others or encouraging others to trade on the information.[75] However, tippees, namely those persons who have received material non-public information from insiders (tippers), are not subject to the same insider trading prohibitions (trading, tipping, recommending) as insiders.[76] Plainly, this is a serious

at 811 (8th Cir 1977), cert denied, 434 US 857 (resignations in 1967 while transactions in 1971); *Dirks v SEC* 463 US 646 (1983) (a former corporate officer was analysed in the same way as would be current officers).

71 *Blyth & Co* 43 SEC 1037 at 1038–40 (1969) (holding the tippee liable).

72 *SEC v Mills*, noted in 20 Sec Reg & L Rep (BNA) 1478 (DDC 28 September 1988).

73 58 F 3d 933 (4th Cir 1995). In this case, the Fourth Circuit rejected the misappropriation theory and acquitted Bryan: at 944. However, the misappropriation theory was eventually adopted by the US Supreme Court in *United States v O'Hagan* in 1997. Thus, had *Bryan* been heard after *O'Hagan*, Bryan would have been convicted of insider trading under the misappropriation theory.

74 *United States v Bryan* 58 F 3d 933 at 937–9 (4th Cir 1995).

75 Securities Law Art 70.

76 See, eg, C Z Qu, 'An outsider's view on China's insider trading law' (2001) 10 *Pacific Rim Law and Policy Jnl* 327 at 338: 'Article 70 [of the Securities Law] does not prohibit a tippee from trading on the inside information himself'.

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loophole.[77] By contrast, almost all other jurisdictions prohibiting insider trading have provided that tippees are subject to the same prohibitions as insiders/tippers.[78]

B Confusion around the theory of insider trading liability

The loopholes concerning the scope of insider trading are inherently related to the confusion around the theory of insider trading liability in China. As discussed before, China's insider trading law has benefited greatly from the US experience. Unfortunately however, it appears that China has relied too heavily on the US experience and has been too ready to whole-implant it. As will be discussed, over time, the United States has developed several different and even conflicting theories of insider trading liability. China appears to have simply taken all of them and put them together, having no regard to the potential conflicts between them. This failure to clearly set out the underlying theory has seriously affected the effectiveness of China's insider trading law.

As discussed before, Art 67 generally provides that 'persons with knowledge of insider information on securities trading are prohibited to take advantage of such inside information to engage in securities trading'.[79]A literal reading of this article may suggest that China adopts the equality of access theory.[80] This implies that anyone with unequal access to insider information would be generally subject to the prohibition. If this is the case, the above discussed loopholes in China's insider trading law would be closed.

However, this situation is seriously undermined by Art 68 and Art 70. As discussed earlier, Art 68 curbs the broad nature of Art 67 by enumerating specific types of persons who are regarded as insiders.[81] The list seems to be wholly based on the *Chiarella-Dirks* classical insider trading theory.[82] Firstly, it covers traditional insiders, such as directors, officers, and substantial shareholders. Secondly, constructive or temporary insiders — staff members of intermediaries including underwriters, accountants, consultants, lawyers — are also listed. Moreover, Art 70 casts a cloud over the belief that China's insider trading regime is predicated on the equality of access theory. In pertinent part, Art 70 provides:

> No *person with knowledge of inside information on securities trading of a company* or *other person who has illegally obtained such inside information* may purchase the

77 This problem may be arguably ameliorated by Art 67 of the Securities Law, the general provision prohibiting insider trading, because tippees are also 'persons with knowledge of inside information'. However, as discussed before, the broad nature of Art 67 may be curbed by Art 68 which specifically lists various types of 'persons with knowledge of inside information'. See Part II(A).

78 See, eg, F A Gevurtz, 'The Globalization of Insider trading Prohibitions' (2002) 15 *Transnational Lawyer* 63 at 76–85 (comparing the insider trading prohibitions in the United States, under the EU Directive, in Australia and in Japan).

79 Securities Law Art 67.

80 For discussion of the equality of access theory, see Part IV(A)(1).

81 See Part II(A).

82 For discussion of the classical theory, see Part IV(A)(2).

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securities of the company or sell such securities he is holding, divulge such information or counsel another person to purchase or sell such securities.[83]

Pursuant to Art 70, there are two types of people who are exposed to insider trading liability. One type is 'persons with knowledge of insider information' as enumerated in Art 68; the other is 'other persons who have illegally obtained such insider information'. It has been argued that the second type of person corresponds to the US-style 'misappropriators' under the misappropriation theory.[84] Thus, it appears that Arts 68 and 70 have jointly imported the current US insider trading law which is based on the combination of the classical theory and the misappropriation theory.

It is thus not unfair to say that when enacting the Securities Law, China's legislators appear to have failed to critically analyse the US insider trading regime. Indeed, they have hurriedly imported the US experience with little debate. But the history of the US insider trading regulation is quite complicated: firstly, the equality of access theory was adopted in the 1960s; then the US Supreme Court replaced it with the classical theory in *Chiarella*, and finally accepted the 'fraud on the source' theory to complement the classical theory in *O'Hagan*.[85] It seems that China's legislators simply put all of them together, without paying adequate attention to their mutual relationships, which has resulted in problems with the scope of insiders in China's insider trading regulation. To the extent that China merely seeks to attain the fruits of US development, without first examining the process from which those fruits were derived, China's insider trading law is much less effective than expected.

IV A comparative analysis of theories of insider trading liability

A The US experience

In order to clear the confusion surrounding insider trading theories and determine which one is most suitable for China, the various theories will be examined by looking at the US experience. As a pioneer in the field of insider trading regulation, the US has developed a comprehensive set of theories for regulating insider trading. An exhaustive account of the historical development of the US insider trading regulation will not be provided, simply because such work has been extensively done by other securities law scholars.[86] The following brief refresher may none the less assist in putting the subsequent discussion in context for readers, especially those less familiar with doctrinal details of the US law.

83 Securities Law Art 70 (emphasis added).

84 See, eg, Guo Feng, 'Insider Trading and Private Right of Action' (2000) 2 *Faxue Yanjiu [Legal Study]* 91 at 94; Liang Yang, *Neimu Jiaoyi Lun [Insider Trading]*, above n 61, pp 210–11. More accurately, it seems that Art 70 relates better to the 'fraud on investors' misappropriation theory than the 'fraud on the source' misappropriation theory which applies in the situation where a person misuses the information in breach of a duty of loyalty to the information's source. For a detailed discussion of the two misappropriation theories, see Part IV(A)(2).

85 For discussion of the development of the US insider trading law, see Part IV(A).

86 There is a vast amount of legal scholarship on the law of insider trading. For some accounts on the development of insider trading regulation in the United States, see, eg, L Loss and

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In the United States, the primary source of insider trading regulation is federal law. In response to the stock market crash of 1929 and the Great Depression that followed, the US Congress passed the Securities Exchange Act of 1934 (Exchange Act)[87] with the broad goal of promoting fairness and integrity in the securities market.[88] For the most part, the federal insider trading regulation results from administrative and judicial interpretations of a broad anti-fraud rule, namely r 10b-5,[89] adopted by the SEC pursuant to authority under s 10(b),[90] an even broader statutory provision.[91] Over time, the courts in the United States have developed several underlying theories of insider trading regulation. More specifically, the first theory appears to be the equal access theory which subsequently was replaced by the fiduciary-duty-based theories. The fiduciary-duty-based theories, including the classical theory and the misappropriation theory, currently underlie the US insider trading regulation.

1 The equality of access theory

For nearly two decades after its promulgation, r 10b-5 had not been used to address insider trading in open markets. This situation was changed by *In re*

J Seligman, *Securities Regulation*, above n 70, Ch 9(B); W K S Wang and M I Steinberg, *Insider Trading*, above n 40; D C Langevoort, *Insider Trading: Regulation, Enforcement, and Prevention*, looseleaf service, West Group A Thomson Co.

87 15 USC §§ 78a-mm (2001).

88 15 USC §78b (2001) (explaining the necessity for regulation of securities transactions in the secondary market).

89 17 CFR § 240.10b-5 (1998). In pertinent part, the text reads as follows:

> It 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 facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) 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 purchase or sale of any security.

90 15 USC § 78j(b) (2001). In pertinent part, the text reads as follows:

> It 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 facility 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.

91 In fact, the text of s 10(b) does not even mention insider trading, and the legislative history does not suggest that Congress intended s 10(b) to create a sweeping prohibition of insider trading. It has been strongly argued that the prohibition against insider trading was not the original purpose of s 10(b), despite the fact that Congress was concerned about insider trading at the time. See, eg, S M Bainbridge, 'Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition' (1995) 52 *Wash & Lee L Rev* 1189 at 1228–37; M P Dooley, 'Enforcement of Insider Trading Restrictions' (1980) 66 *Va L Rev* 1 at 55–69; F H Easterbrook, 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information' (1981) 1981 *Sup Ct Rev* 309 at 317–20.

Cady, Roberts & Co,[92] where the SEC articulated what became known as the 'disclose or abstain' rule: corporate insiders in possession of material information are required to either disclose that information or abstain from trading.

The administrative ruling in *Cady Roberts* was affirmed by the Second Circuit in *SEC v Texas Gulf Sulphur Co* in 1968.[93] In this case, Texas Gulf Sulphur Corporation had kept secret information about a significant ore discovery in order to facilitate the acquisition of surrounding parcels of land. The defendants, all of whom were convicted, were employees of Texas Gulf Sulphur who made open-market purchases or exercised stock options before the public disclosure of the information.

The policy foundation on which the Second Circuit supported the disclose or abstain rule was the equality of access theory. According to the Second Circuit, there is a 'justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively *equal access* to material information'.[94] The Second Circuit held that because any persons with access to material, non-public information enjoy an advantage that hard work and discriminating research cannot overcome, the use of this advantage in securities transactions was not just 'unfair', but fraudulent as well.[95] Thus what was born is known as the equality of access theory.[96] Under this theory, anyone with unequal access to inside information, whether they are corporate insiders or outsiders, have a duty of disclosure before trading and, if they fail to disclose, they will breach the duty and thus r 10b-5.

2 Fiduciary-duty-based theories: the classical theory and the misappropriation theory

The equality of access theory was squarely rejected by the US Supreme Court on the grounds that it departs from traditional common law principles and casts far too wide a net on insider trading. The court then imported the common law notion of fiduciary duty into the federal securities law and, by doing so, completely changed the path on which the US insider trading regulation follows.

(1) Chiarella v Untied States

In *Chiarella v United States*,[97] the US Supreme Court analysed insider trading liability under s 10(b) and r 10b-5. Vincent Chiarella was an employee of a financial printer who, through his employment, handled documents containing five announcements of corporate takeover bids.[98] Although the identities of the acquiring and target companies of the takeover were intentionally

92 40 SEC 907 (1961).
93 401 F 2d 833 (2d Cir 1968), cert denied, 394 US 976 (1969).
94 Ibid, at 848.
95 Ibid, at 848 n 33.
96 See, eg, R W Painter et al, 'Don't Ask, Just Tell: Insider Trading After *United States v O'Hagan*' (1998) 84 *Va L Rev* 153 at 163 (stating that *Texas Gulf Sulphur* established the equality of access theory); F A Gevurtz, 'The Globalization of Insider trading Prohibitions' (2002) 15 *Transnational Lawyer* 63 at 77 (contending that 'the equal access rule' was adopted by *Cady, Roberts* and *Texas Gulf Sulphur*).
97 445 US 222 (1980).
98 Ibid, at 224.

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concealed for the purpose of confidentiality, Chiarella succeeded in decoding them.[99] Without declaring his knowledge concerning the prospective takeover bids, Chiarella purchased target company stocks and then sold them for a profit immediately following the public announcement of the takeover.[100] The key issue in this case was whether Chiarella had a duty to disclose the non-public information after obtaining it.

To begin with, the court held that a duty to speak is essential for nondisclosure to constitute fraud.[101] Then, as to when a duty to speak arises, it rejected the equality of access theory by ruling that the equal access theory supports too broad a duty to disclose and departs from the common law. In an effort to find when a duty to disclose does arise, the court looked to the common law and held that a duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them'.[102]

Because this theory is grounded on the classical common law fraud, this theory was called the 'traditional' or 'classical' theory of insider trading liability. Under this classical theory, the court set Chiarella free on the grounds that he had no fiduciary relationship with the sellers of the target company's securities.[103] This was clearly a disturbing decision, and several members of the court expressed their concerns and gave several alternative theories to impose insider trading liability.

In his dissenting opinion, Chief Justice Burger, questioned the very basis of the majority opinion, namely, the general rule of common law that the parties to a transaction have no duty to disclose information except where there is some confidential or fiduciary relationship between them. Burger argued that 'this rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means',[104] and that 'any person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading'.[105] Justice Stevens lent some support to an alternative theory that Chiarella owed a fiduciary duty to his employer's customer, the acquiring corporation, and his misappropriation of confidential information from his employer therefore constituted a fraud against the acquiring corporation.[106] The majority of the court, however, refused to address this 'fraud on the source' argument because it had not been presented to the jury.[107]

Although both Chief Justice Burger and Justice Stevens based their reasoning on misappropriation of information from a third party rather than

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99 Ibid.
100 Ibid.
101 Ibid, at 235.
102 Ibid.
103 Ibid, at 232.
104 Ibid, at 240.
105 Ibid (Burger CJ dissenting).
106 Ibid, at 238 (Stevens J concurring):

> if we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted "a fraud or a deceit" upon those companies "in connection with the purchase or sale of any security".

107 Ibid, at 237.

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corporations whose securities are traded, their theories are essentially different. Burger's theory, the 'fraud on investors' misappropriation theory, premises insider trading liability on a trader's duty to disclose his misappropriated information to *other market participants*. In contrast, Stevens's theory, the 'fraud on the source' misappropriation theory, based liability on a trader's duty to disclose to *the source* of his misappropriated information. For the purpose of brevity and, more importantly, because the 'fraud on the source' theory has been officially adopted by the United States,[108] the phrase 'misappropriation theory' used in this article generally refers to the 'fraud on the source' misappropriation theory, unless otherwise indicated.

Justice Harry Blackmun, in a dissenting opinion joined by Justice Thurgood Marshall, argued in favour of the equality of access theory by stating that:

> persons having access to confidential material information that is *not legally available* to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.[109]

This equality-of-access based standard appears to be the broadest of the theories set forth in the separate *Chiarella* opinions. It prohibits any misuse of material, non-public information, regardless of whether the information is obtained unlawfully or not, as long as the information is legally unavailable to others.

(2) Dirks v SEC

Three years later in *Dirks v SEC*,[110] a case involving trading by persons receiving information from a corporate insider's tippee, the Supreme Court adhered to its fiduciary-duty-based theory and once again emphasised that insider trading liability under r 10b-5 occurs only when the defendant owes a fiduciary duty to shareholders with whom he is trading. However, the court took great pains to find the requisite fiduciary duty.

In this case, Raymond Dirks, an investment analyst, received a tip from Ronald Secrist, a former officer of Equity Funding, that the corporation's assets were vastly overvalued as a result of fraudulent corporate practices. Secrist also told Dirks that various regulatory agencies somehow did not respond to similar charges coming from other company employees, and therefore encouraged Dirks to verify and expose the fraud. In the course of his investigation, Dirks did find the fraud, and then divulged the information to several of his clients who in turn sold their holdings as a result.[111]

The court recognised that it would be difficult to find a breach of fiduciary duty between tippees and their trading counterparts for the purposes of tipping liabilities.[112] In order to solve this problem, the court went out of its way to find a fiduciary duty to remedy the classical theory. Firstly, the court

108 *United States v O'Hagan* 521 US 642 (1997).

109 445 US 222 at 251 (Blackmun J concurring) (emphasis added).

110 463 US 646 (1983).

111 Ibid, at 649.

112 'This requirement of specific relationship between the shareholders and the individual trading on insider information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information': *Dirks v SEC* 463 US 646 at 655 (1983).

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technically treated intermediaries, including underwriters, accountants, lawyers and consultants, as tippers rather than tippees, even though these intermediaries were *actually* tippees.[113] This group of persons is referred to as constructive or temporary insiders.

Secondly, as to those outsiders who can only be treated as 'tippees', the court contended that tippees can be held liable on the grounds that they violate their fiduciary duty inherited from tippers/insiders who breach their fiduciary duty to disclose confidential information in the first place. In order to judge whether insiders breached their fiduciary duty, the court provided a 'personal benefit' test, namely, 'whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings'.[114] Therefore, unless tippers/insiders gain personally from their disclosure, they will not be found to have breached their fiduciary duty, and no derivative duty will be passed on to tippees.

(3) United States v O'Hagan

In 1997, over 17 years after Justice Stevens expressed his approval of the 'fraud on the source' misappropriation theory in *Chiarella*, the Supreme Court finally endorsed this theory in *United States v O'Hagan*.[115] This case involved trading in the securities of a tender offer target company by an attorney whose law firm represented the prospective bidder. James Herman O'Hagan was a partner of Minneapolis Minnesota of Dorsey & Whitney, the law firm retained in July of 1988 by Grand Met PLC (Grand Met) for a planned tender offer for the stock of Minneapolis-based Pillsbury Company (Pillsbury). Although O'Hagan did not personally represent Grand Met, he learned of the tender offer from one of his colleagues and began purchasing call options for Pillsbury stock as well as shares of common stock. After Grand Met announced its tender offer for Pillsbury in October 1988, O'Hagan sold his options and stock at a profit of over $4.3 million.[116]

The Supreme Court adopted the misappropriation theory based on the following two grounds.[117] Firstly, the court explained why the misappropriation theory encompasses the 'deception' element which is required under s 10(b) and r 10b-5. In the view of the court, s 10(b), literally read, is not limited to deception of a purchaser or seller of securities, but rather covers any deceptive device used 'in connection with the purchase or sale of any security'.[118] Then, the court held that misappropriators deal in deception because they pretend to be loyal to the principal while secretly converting the principal's information for personal gain, and this conduct '"dupes" or defrauds the principal'.[119] Further, the court elaborated on the other requirement of s 10(b) that the misappropriator's deceptive use of misappropriated information must be 'in connection with the purchase or sale of [a] security', and concluded that this requirement was satisfied because the

113 *Dirks v SEC* 463 US 646 at 655 n 14 (1983).
114 Ibid, at 663.
115 521 US 642 (1997).
116 Ibid, at 648.
117 Ibid, at 667.
118 Ibid, at 651.
119 Ibid, at 653–4.

misappropriator's undisclosed securities trade itself consummates the deception.[120]

Thus, under the misappropriation theory, perpetrators do not deceive the shareholders of companies whose shares they trade, but those who entrusted them with confidential information. Despite the differences in identifying who is deceived, the classical theory and the misappropriation theory are both premised on the presence of a 'fiduciary duty'. More specifically, a fiduciary duty creates a duty to disclose one's trades to their trading counterparts, under the classical theory, while to the source of information, under the misappropriation theory. For this reason, these two theories can be collectively labelled 'fiduciary-duty-based' theories.

B China's choice: The equality of access theory vs fiduciary-duty-based theories

This part undertakes an in-depth analysis of whether the equality of access theory or the fiduciary-duty based theory is a better choice for China. As discussed above, the United States firstly employed the equality of access theory, and then replaced it with the fiduciary-based theories, including the classical theory and the misappropriation theory. This by no way suggests, however, that the current US insider trading theories, namely the fiduciary-based theories, are necessarily superior to the equality of access theory. Rather, as discussed below, the fiduciary-duty-based theory suffers serious problems and appears less effective to promote investor protection than the equality of access theory. This is particularly so when the unique circumstances in China are considered.

1 The unsuitability of fiduciary-duty-based theories

Current US insider trading theory, namely the fiduciary-duty based theory, has been riddled with problems. As discussed before, in *Chiarella*, the US Supreme Court imported the common law concept of fiduciary duty into insider trading law in an effort to fit insider trading into the traditional notion of fraud. However, since this approach has turned out to be too narrow, the court had to struggle to expand the breadth of insider trading regulation in *Dirks* and *O'Hagan*, albeit at the price of new layers of conceptual difficulty. In short, it seems that the importation of the common law conception of fiduciary duty has set a wrong direction for the advancement of US insider trading law. Moreover, the reliance on the notion of fiduciary duty is particularly unsuitable for China as it is traditionally undeveloped there.

(1) Problems with the classical theory

a. Problems with the fiduciary duty requirement

As discussed earlier, in order to identify a duty to disclose before trading, the classical theory borrows the fiduciary duty concept from common law. However, the notion of fiduciary duty appears to be inadequate in serving as a basis for insider trading law. Traditionally under the common law, corporate

120 Ibid, at 656: 'the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities'.

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insiders, such as directors and officers, do not owe fiduciary duties to individual shareholders but rather to the corporation as a legal entity. Thus, there would be no fiduciary duty on the part of corporate insiders in their private dealing with shareholders.[121] Even if corporate insiders can be regarded as standing in a fiduciary duty relationship to shareholders when trading stock,[122] the classical theory cannot account for all of the cases that modern insider trading law recognises as insider trading.

One huge category of insider trading cases, involving outsiders who owe no fiduciary duties to the shareholders with whom they trade, falls well outside of the classical theory parameters. Because of its fiduciary-duty requirement, the classical theory can only reach traditional insiders, such as corporate directors and officers. In order to extend to outsiders trading liability on material, non-public information, the US Supreme Court had to adopt the misappropriation theory, even though this theory has many serious problems.[123]

Apart from outsider trading, the classical theory also ironically fails to cover traditional insiders. This basically happens in two situations. Firstly, the fiduciary duty principle may not easily resolve insider trading involving *sales* of securities rather than *purchases* of securities. Under the classical theory, insiders may sell shares to prospective shareholders on the basis of material, non-public information with impunity.[124] Because prospective shareholders are not yet shareholders, insiders would have no fiduciary relationship with them before trading.[125] Absent a fiduciary duty, there is no insider trading liability under the classical theory.

In order to solve this problem, the *Chiarella* court employed an 'incipient shareholder' rule to find the existence of fiduciary duty. Under this approach, it is fair to extend the law of fiduciary obligation to prospective shareholders because they are incipient shareholders and will soon be real shareholders.

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121 See, eg, H LWilgus, 'Purchase of Shares of a Corporation by a Director from a Shareholder' (1910) 8 *Mich L Rev* 267 at 267:

> The doctrine that officers and directors [of corporations] are trustees of the stockholders . . . does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their official position.

122 In the United States, directors now have a modern fiduciary duty to disclose material non-public information to shareholders before trading with them. See, eg, *Oliver v Oliver* 45 SE 232 (Ga 1903). Alternatively, although directors generally owe no duty to disclose material facts when trading with shareholders, such a duty can arise in 'special circumstances' in which directors conceal their identities and fail to disclose price-sensitive facts. See, eg, *Strong v Repide* 213 US 419 (1909). For commentary on the development in this area, see, eg, W K S Wang and M I Steinberg, *Insider Trading*, above n 40, pp 1107–29; J Seligman, 'The Reformulation of Federal Securities Law Concerning Nonpublic Information' (1985) 73 *Geo L J* 1083 at 1091.

123 For analysis on the problems with the misappropriation theory, see Part IV(B)(1).

124 See, eg, A Grey Anderson, 'Fraud, Fiduciaries, and Insider Trading' (1982) 10 *Hofstra L Rev* 341 at 356; A C Pritchard, '*United States v O'Hagan*: Agency Law and Justice Powell's Legacy for the Law of Insider Trading' (1998) 78 *BU L Rev* 13 at 26.

125 *Marhart, Inc v Calmat Co* No. 11820, 1992 WL 212587, at ?1 (Del Ch 10 August 1992): 'fiduciary duties run to stockholders, not prospective shareholders'; A Strudler and E W Orts, 'Moral Principal in the Law of Insider Trading' (1999) 78 *Tex L Rev* 375 at 392: 'The prospective purchaser is a stranger to the company, and no fiduciary duties are owed to strangers'.

This reasoning is rather strained and, in the words of one commentator, 'this extension would be an evasion'.[126]

Secondly, the classical theory may be squarely applied to insider trading in publicly traded equity securities, but it is a stretch to apply it to insider trading in other types of securities such as options and debt securities. That insiders can profit by trading in options on the basis of inside information should be readily apparent. However, the classical theory has difficulty curbing this situation, because the options seller is not necessarily a shareholder of the issuer of the underlying security and therefore may not be owed any fiduciary duty by the insider. For this reason, a number of courts in the United States refused to impose insider trading liability in cases of options trading.[127] This problem was addressed in 1984 by the Insider Trading Sanction Act which changed the then-existing law and expressly prohibited insider trading in options or other derivative instruments.[128] However, as one commentator said, this legislative effort 'creates a conceptual anomaly in the law'.[129]

The same problem is present in cases of debt securities trading. Yet, the application of insider trading law to debt securities has received very little judicial attention in the United States. Even though debt securities are less susceptible to price fluctuations because they are fixed obligations, many commentators have argued that there is no sound reason why insider trading law should distinguish between equity and debt securities.[130] If insider trading liability as applied to trading in publicly held stock should extend to publicly held debt under the same criteria, the classical theory may be problematic. The conceptual difficulty arising here is that neither the corporation nor its officers and directors ordinarily have fiduciary duties to debt-holders.[131]

b. Problems arising from the 'personal benefit' test for tipping liability

In *Dirks*, the US Supreme Court extended the classical theory to insider tipping liability, but nevertheless erected a barrier in the form of the 'personal benefit' test. Under this test, an insider would not breach his or her fiduciary duty in disclosing insider information and thus the tippee would not inherit, much less breach, a fiduciary duty as required by the classical theory, unless the insider personally benefited from the disclosure. This test seems quite problematic.

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126 Strudler and Orts, ibid, at 392.

127 See, eg, *Laventhall v General Dynamics Corp* 704 F 2d 407 (8th Cir), cert Denied, 464 US 846 (1983); *O'Connor & Assoc v Dean Witter Reynolds Inc* 529 F Supp 1179 (SDNY 1981).

128 See 130 Cong Rec S8913 (29 June 1984); 130 Cong Rec H7758 (25 July 1984).

129 D C Langevoort, *Insider Trading: Regulation, Enforcement, and Prevention*, above n 86, §3.03[1] at 20.

130 A Strudler and E W Orts, 'Moral Principal in the Law of Insider Trading' (1999) 78 *Tex L Rev* 375 at 392–3: 'Because firms finance themselves through issuing public debt as well as equity, both of which are often traded in securities markets, a formal legal distinction between debt and equity in insider trading law does not make sense'. See also Note, 'Insider Trading in Junk Bonds' (1992) 105 *Harv L Rev* 1720 at 1738–9 (arguing on economic grounds that insider trading law should not distinguish between equity and public debt).

131 Debt-holders' rights are normally limited to the express terms of the contract and an implied covenant of good faith. See, eg, L E Mitchell, 'The Fairness Rights of Corporate Bondholders' (1990) 65 *NYU L Rev* 1165 at 1175 (explaining that bondholders are limited to the contractual terms for their remedies); E W Orts, 'Shirking and Sharking: A Legal Theory of the Firm' (1998) 16 *Yale L & Pol'y Rev* 265 at 306–8, 323–35 (stating that creditors have no extra-contractual protection against a corporation).

Most fundamentally, it is unclear why a 'personal benefit' to an insider is relevant to wrongfulness of the tippee's conduct. From the perspective of a third party in the market, the key point is whether someone traded on privileged information, and it is irrelevant to ask from whom they got the privileged information, let alone whether the tipper benefited from the tipping. As the dissenting judge pointed out, the shareholder's injury was not eliminated by the fact that the insiders themselves did not gain personally from the breach.[132] Indeed, the impact on investors would seem to be exactly the same regardless of whether or not the tipper/insider gained personally from the tipping.

In practice, the 'personal benefit' test poses a frustrating problem as to the selective disclosure practice — the practice of companies selectively disclosing material, non-public information to financial analysts, institutional investors and other favoured market participants before making full disclosure of the same information to the general pubic. This practice closely resembles the tipping of insider information, but it cannot be regulated under the tipping regime under *Dirks*, because it is very difficult to prove that company selective disclosure is motivated by personal benefit.

Faced with the inability of insider trading law to effectively address the selective disclosure practice, the SEC promulgated Regulation FD (Fair Disclosure)[133] to create a non-insider trading based mechanism to deal with it.[134] Regulation FD basically provides that 'when an issuer, or person acting on its behalf, discloses material non-public information to [selective] persons . . ., it must make public disclosure of that information'.[135] Noteworthy is that the underlying concerns of promulgating Regulation FD appear to be related to the equality of access theory, which prompted one commentator to say that Regulation FD in effect resurrects the discarded equality of access theory.[136] This clearly exposes the weaknesses of the classical theory, while at the same time revealing the strengths of the equality of access theory.

(2) Problems with the misappropriation theory

a. Dubious legal reasoning

The legal reasoning of the misappropriation theory is dubious. The US Supreme Court has struggled to expand the breadth of insider trading liability established by the classical theory but, at the same time, it has to fit the *Chiarella-Dirks* requirement of a breach of fiduciary duty. Under the misappropriation theory, the fiduciary duty is owed to the source of

132 *Dirks v SEC* 463 US 646 at 673 (1983) (Justice Blackmun dissenting).

133 See Selective Disclosure and Insider Trading, Exchange Act Release No 43154, [2000 Transfer Binder] Fed Sec L Rep, CCH, ¶86,319 (15 August 2000) (Selective Disclosure Release).

134 In order to address the selective disclosure problem outside of the constraints of insider trading law, the SEC emphatically characterised Regulation FD as 'a new issuer disclosure rule' under its authority to mandate disclosure by public companies. Selective Disclosure Release, ibid, at ¶83,676. For commentary on Regulation FD, see, eg, T A Eckstein, 'The SEC's New Regulation FD: A Return to The Parity Theory?' (2001) 69 *Uni of Cincinnati L Rev* 1289; R B Thompson and R King, 'Credibility and Information in Securities Markets After Regulation FD' (2001) 79 *Washington Uni L Qrtly* 615.

135 Selective Disclosure Release, above n 133, at ¶83,676.

136 T A Eckstein, 'The SEC's New Regulation FD: A Return to The Parity Theory?' (2001) 69 *Uni of Cincinnati L Rev* 1289 at 1313.

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information which is extrinsic to the securities transaction. The *O'Hagan* court, however, uses legal gymnastics to reconcile the breach of this duty with the statutory language of s 10(b). In the court's view, the fraud on the information's source is in connection with the purchase or sale of a security within the meaning of s 10(b), because the fraud occurs when the fiduciary buys or sells the securities not when the confidential information is obtained.[137]

Indeed, the misappropriation theory can be criticised as 'a theory in search of a rationalization'.[138] The theory focuses on a fraud on the source of information, rather than market participants who may have little or no relationship with securities transactions. For example, in the United States, the misappropriation theory has been used to protect newspapers from their columnists,[139] patients from their psychiatrist,[140] spouses from each other,[141] parents from their children,[142] and State lotteries from their commissioners,[143] and so on. All the above relationships are formed outside the securities market but the misappropriation theory connects them with securities trading for the purpose of establishing acts of securities fraud which fall within the zones of securities laws. This search for the required fiduciary relationships which can give rise to liability appears to be a results-oriented approach.

The dubious reasoning of the misappropriation theory may have a negative impact on the investor protection goal which it purports to serve. Under this theory, the only injury proximately caused by the deception of nondisclosure is to the source of information, and the harm to investors stems from the misappropriator's trading, not from the deception which creates liability under s 10(b). Thus, the theory identifies the information's source, not the investor on the other side of the insider trade, as the defrauded victim. This would present an obstacle to the private right of action: because investors are not regarded as the defrauded victim, they have no standing to initiate private actions. This was exactly the essence of the court's view in *Moss v Morgan Stanley Inc*.[144]

Thus, under the misappropriation theory, investors would have no standing to bring private civil suits. This major loophole has been plugged by the US Congress who amended the Exchange Act to provide contemporaneous traders

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137 *United States v O'Hagan* 521 US 642 at 656 (1997): '[t]he securities transaction and the breach of duty . . . coincide'.

138 H S Bloomemthal, *Securities Law Handbook*, West Group, 1998, p 1183. For more criticism on the dubious reasoning of the misappropriation theory, see, eg, M P Kenny and T D Thebaut, 'Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)' (1995) 59 *Alb L Rev* 139; J R Beeson, 'Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory' (1996) 144 *U Pa L Rev* 1077; D M Nagy, 'Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan* Suggestion' (1998) 59 *Ohio St LJ* 1223.

139 *Carpenter v United States* 484 US 19 (1987).

140 *United States v Willis* 737 F Supp 269 (SDNY 1990).

141 *United States v Chestman* 947 F 2d 557 (2d Cir 1991) (en banc), cert denied, 503 US 1004 (1992).

142 *United States v Reed* 601 F Supp 685 (SDNY), rev'd on other grounds, 773 F 2d 477 (2d Cir 1985).

143 *United States v Bryan* 58 F 3d 933 (4th Cir 1995).

144 719 F 2d 5 (2d Cir 1983), cert denied, 465 US 1025 (1984).

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with an express right of action under s 20A,[145] because the result of *Moss* is 'inconsistent with the remedial purposes of the Exchange Act'.[146] Even though desirable from a policy point of view, this revision of the legislation creates a conceptual anomaly in the law. If, as the *O'Hagan* court has concluded, investors are not owed fiduciary duties by insider traders under the misappropriation theory, what the US Congress is saying is that insider trading liability attaches in some circumstances *absent* any fiduciary relationship.

b. Liability loopholes

Under the misappropriation theory, the deception is the act of failing to inform the information's source of the intent to use misappropriated information to trade securities, not the act of trading itself. In other words, the misappropriation theory focuses on a fiduciary duty to the source of information which gives rise to a duty to disclose the intent to trade and, thus, absent disclosure, to deception. Thus, the requisite elements of the misappropriation theory include, amongst other things, (1) the existence of a prior fiduciary duty; and (2) a failure to disclose the intent of trading to the source of information. Serious liability loopholes arise from these requirements.

Firstly, if the information had been misappropriated for securities trading by a person not standing in a fiduciary relationship with the source, there would have been no violation under the misappropriation theory. Thus, non-fiduciaries who wrongly obtain information, such as thieves, could slip through the insider trading law.[147] Because non-fiduciaries owe no requisite fiduciary duty to the source, and would not have defrauded the source, no misappropriation theory liability would arise, even though they may be guilty of other offences such as burglary and theft.

Secondly, if a brazen misappropriator discloses his or her trading plans to the source, then the subsequent trade would not violate r 0b-5, even if the source of information did not give permission to trade and objected strenuously.[148] The *O'Hagan* court stated:

> full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no 'deceptive device' and thus no § 10(b) violation — although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.[149]

Undoubtedly, if after disclosure, the fiduciary can trade even without the permission of the source, then it would be safer to do so with the consent of the source.

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145 15 USC §78t-1 (1994).

146 See ITSFEA House Report, HR Rep No 100-910, at 27 (1988), reprinted in 1988 USCCAN 6043 at 6063. The US Congress expressly pointed out that s 20A is 'specifically intended to overturn court cases [like *Moss*] which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory': ibid.

147 See, eg, D M Nagy, 'Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan* Suggestion' (1998) 59 *Ohio St LJ* 1223 at 1252.

148 This kind of trading has also been referred to as 'candid trading': S Prakash, 'Our Dysfunctional Insider Trading Regime' (1999) 99 *Colum L Rev* 1491 at 1506.

149 *United States v O'Hagan* 521 US 642 at 655 (1997).

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The above situations are serious, because the impact on the market would seem to be precisely the same, regardless of securities trading on misappropriated information carried out by a deceitful fiduciary, by a non-fiduciary or by a brazen fiduciary. As Justice Thomas pointed out in his dissent in *O'Hagan*, 'even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of the source of the information'.[150] Thus, even the majority of the *O'Hagan* court conceded that s 10(b) is 'only a partial antidote to the problems it was designed to alleviate'.[151]

(3) The local situation in China

A sensible conclusion as to the feasibility of implantation of any foreign legal rules won't be reached without taking into account the local situation in China. Apart from the problems inherent with the fiduciary-duty-based theories, the particular conditions in China make the theory even more unsuitable for China. Of particular relevance are the notion of fiduciary duty and the inefficacy of law enforcement. Indeed, as one US commentator warned, the US insider trading law 'at times fails to accord fair treatment to market participant and impedes commercial certainty', and thus 'countries abroad may be ill-served by embracing the US model'.[152]

a. The undeveloped concept of fiduciary duty

The undeveloped and inadequate notion of fiduciary duty in China may pose a considerable obstacle to adopting fiduciary-duty-based theories. As discussed previously, the US Supreme Court imported the common law concept of fiduciary duty to establish insider trading law. Indeed, the notion of fiduciary duty lies at the heart of insider trading liability under both the classical theory and the misappropriation theory. More specifically, the critical determination is whether a fiduciary relationship exists and creates a duty to disclose to the trading party in the classical theory case, and to the source of information in the misappropriation theory case. In the presence of a duty to disclose, nondisclosure may amount to fraud.

It seems, however, that even the US Supreme Court was uncertain about, and had been struggling with the scope of the fiduciary relationship under r 10b-5. This is evident by the choice of language the court used: a more expansive 'relationship of trust and confidence' in some cases[153] and a more restrictive 'fiduciary relationship' in others.[154] Neither the scope of fiduciary relationship nor that of confidential relationship is clear. In the United States, relationships traditionally considered to be fiduciary include: attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, partner and partner, and corporate officer or director and

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150 Ibid, at 690 (Thomas J concurring in the judgment in part and dissenting in part).

151 Ibid, at 659 n 9.

152 M I Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *Uni of Pennsylvania Jnl of International Economic Law* 635 at 635.

153 See, eg, *Chiarella v United States* 445 US 222 at 228 (1980); *United States v Reed* 601 F Supp 685 at 696 (SDNY), rev'd on other grounds, 773 F 2d 477 (2d Cir 1985).

154 See, eg, *United States v O'Hagan* 521 US 642 at 652 (1997).

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shareholder.[155] Apart from the traditional types, many other types of relationships can also be fiduciary in nature, and thus the notion of fiduciary is quite vague.

The phrase confidential relationship is even more indeterminate, because it has no traditional common law concept. Especially unclear is whether certain non-business relationships, including family and other personal relationships, can be considered as confidential relationships under the misappropriation theory. For example, in *United States v Reed*,[156] the father-son relationship was regarded as one of trust and confidence, while in *United States v Chestman*,[157] the husband-wife relationship was found not to be confidential per se. Thus, the indeterminacy of the fiduciary relationship makes it very hard to determine in advance exactly whether activity by a family member falls within reach of the misappropriation liability.

To solve this problem, the SEC promulgated r 10b5-2 in 2000,[158] setting forth a non-exclusive description of the circumstances in which a 'duty of trust or confidence' exists for the purposes of the misappropriation theory under s 10(b) and r 10b-5. Under r 10b5-2, certain types of close family relationships — spouses, parents, children and siblings — are now presumed to be fiduciary in nature. In contrast, other family relationships, such as cousins, grandparents, and friendships are not, and the prosecutor needs to prove, under the facts and circumstances, that an expectation of confidence existed between the traders and their source.

Although r 10b5-2 has provided some guidance on the status of family relationships, some uncertainty around the issue remains. For those relationships which are not presumed to be fiduciary in nature under r 10b5-2, their status may vary depending on specific facts and circumstances. One still needs to apply a fact-specific analysis as to whether a particular relationship suffices to engender a duty of trust and confidence under the misappropriation theory. Indeed, this is a vexing problem, and even Americans have wrestled with it for centuries.[159] If the US courts find it difficult to handle this task, the Chinese courts will find it even harder because there is no traditional concept of fiduciary duty in China.

As a civil law country, China did not even have the legal term 'fiduciary duty' (*Xinyi Yiwu*) until very recently. In 1993 when the Company Law was enacted, legislators implanted some principles of fiduciary duty from overseas. At present, however, the notion of fiduciary duty is still at its earliest stage in China and far from developed. For instance, the duty of care is largely absent in China's Company Law, and the duty of loyalty is far too simple and

155 See, eg, J C Coffee, 'From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics' (1981) 19 *Am Crim L Rev* 117 at 150; A W Scott, 'The Fiduciary Principle' (1949) 37 *Cal L Rev* 539 at 541.

156 601 F Supp 685 (SDNY), rev'd on other grounds, 773 F 2d 477 (2d Cir 1985).

157 947 F 2d 557 at 564 (2d Cir 1991) (en banc), cert denied, 503 US 1004 (1992).

158 17 CFR §240.10b5-2 (2001).

159 See, eg, D C Langevoort, *Insider Trading: Regulation, Enforcement, and Prevention*, above n 86, §3.02, at 3 (stating that common-law courts have struggled for centuries in deciding the scope of fiduciary duty); R W Painter et al, 'Don't Ask, Just Tell: Insider Trading After *United States v O'Hagan*' (1998) 84 *Va L Rev* 153 at 190–1 (stating that the scope of fiduciary duties lacks clarity).

hard to apply in practice.[160] Thus, fiduciary duties are not clear even in the context of shareholder relations, let alone in other contexts. Plainly, this problem will seriously undermine the workability of the fiduciary-duty-based theories in China.

Further, it is doubtful that the r 10b5-2 approach can take root in China. Without the basis of the traditional notion of fiduciary duty, it would be very difficult for the Chinese to judge whether there is a fiduciary duty between, for instance, investment bankers and their clients; doctors and their patients; taxi drivers and their passengers; newspaper columnists and their employers and their readers; sons and their fathers; husbands and their wives; and so on. Thus, if fiduciary duty could be said to be an undeveloped term in the company context, then it is totally alien in these situations.

b. Ineffective enforcement framework

As discussed before, the US current insider trading regime, premised on the classical theory and the misappropriation theory, has serious shortcomings. However, it has been widely accepted that insider trading is relatively effectively regulated in the United States, at least in terms of the number of reported insider trading cases.[161] One major reason for this is that the US securities regime maintains an effective enforcement framework which is based on government as well as private actions, and thus induces strong law compliance.[162] Thus, even though the US insider trading law is far from ideal, effective enforcement elevates it to pre-eminence amongst securities markets around the world. However, since China lacks such an effective enforcement framework, it can hardly expect the same results that the United States has achieved by simply transplanting US insider trading regulation.

Firstly, with its capable personnel and plentiful resources, the SEC in the United States plays a crucial role in fighting insider trading, and has been said to be 'the most significant ingredient comprising effective enforcement of the US securities law'.[163] By contrast, the CSRC, due to resource constraints, is far from effective in practice. For instance, in Australia where the total population is about 20 million, the Australian Securities and Investments Commission (ASIC) received an appropriation of AU$162.8 million in 2002–2003 and employed 1396 full time equivalent staff during that year.[164] In comparison, by the end of December 2002, there were about 68 million

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160 See, eg, Kaiping Zhang, *Yingmei Gongsi Dongshi Falu Zhidu Yanjiu [Study on Director Duty at Common Law]*, 1st ed, Kaiping Zhang, Law Press, 1998, p 313.

161 A study has shown that in a period of three years alone, from 1994 to 1997, there were 77 convictions brought by the US Department of Justice and 189 civil cases brought by the SEC. This number is far more than that of any other country. For example, there were only 23 convictions in the United Kingdom for a period of 14 years, from 1980 to 1994. See L Semaan et al, 'Is Insider Trading a Necessary Evil for Efficient Markets?: An International Comparative Analysis' (1999) 17 *Company and Securities L Jnl* 220 at 244.

162 M I Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *Uni of Pennsylvania Jnl of International Economic Law* 635 at 672.

163 Ibid, at 674.

164 See The Australian Securities and Investments Commission, 2002/03 Annual Report, available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/Annual+reports?openocument> (accessed 20 June 2004).

investors in China, while there were only about 1465 CSRC staff.[165] Moreover, there are also some problems with the regulatory power and independence of the CSRC, which further limits the efficacy of the agency.

Secondly, US judges seem to be willing to and able to collaborate with the SEC to combat insider trading.[166] But Chinese judges are much less capable and are also more reluctant than their US counterparts to join the war against insider trading. An important reason for this is that Chinese judges lack the necessary knowledge and experience to deal with securities cases, especially complicated insider trading cases. In China, judges are traditionally selected from non-legal careers, such as military and governmental officials, who normally have received little structured legal educations.[167]

Thirdly, the weakness of government enforcement is compounded by the lack of private enforcement because, as noted before, private civil liability for insider trading is currently unavailable in China. In the United States, private actions serve an important function to assist the SEC in detecting insider trading cases and providing an additional powerful deterrent to potential perpetrators.[168] The SEC itself has argued that it does not have adequate resources to provide enforcement at levels sufficient to deter insider trading and as such private enforcement is a necessary complement.[169] In sum, the participation of the aggrieved issuers and shareholders in the enforcement of insider trading regulation, to a considerable degree, compensates the inadequacy of government enforcement.

2 Adoption of the equality of access theory

The foregoing discussion has brought to light a number of problems with the classical theory and the misappropriation theory as adopted by the existing US insider trading law. It is thus submitted that the equality of access theory is a better choice. The equality of access theory is different from the fiduciary-duty-based theories in that a duty to disclose before trading arises from unequal access to information, rather than a fiduciary duty. The legal analysis of this theory seems to be more logical and more persuasive.

This part seizes compelling support from several sources. First, the equality of access theory has several advantages over other alternative theories.

165 The China Securities Regulatory Commission, *Zhongguo Zhengquan Qihua Tongji Nianjian 2003 [China Securities and Futures Statistical Yearbook 2003]*, Baijia Publishing House, 2003, p 286.

166 S M Bainbridge, 'Insider Trading Regulation: The Path Dependent Choice between Property Rights and Securities Fraud' (1999) 52 *SMU Law Rev* 1589 at 1635–40 (explaining why judges are willing to aid and abet the SEC's efforts to fight insider trading).

167 For instance, a 1997 survey has shown that out of 250,000 judicial officers in China's court system, only 5.6% have bachelor degrees and in the total of 180,000 procuratorial officers in China's procuratorate system, only 4% hold bachelor degrees: Weili Zhang, 'China Needs More Excellent Judicial Talents', *Legal News Daily*, 3 October 1997, p 3.

168 In addition to its role in providing compensation to victims of insider trading, private action has an important role in deterring illegal conduct. See, eg, D C Langevoort, 'Capping Damages for Open-Market Securities Fraud' (1996) 38 *Arizona L Rev* 639 at 652 (assuming necessity of private action); J C Alexander, 'Rethinking Damages in Securities Class Actions' (1996) 48 *Stanford L Rev* 1487 at 1490 (recognising 'the need for a private litigation remedy as supplement to SEC enforcement').

169 See H R Rep No 100-910, at 14 (1988) (citing testimony at legislative hearing on Insider Trading and Securities Fraud Enforcement Act of 1988 of SEC Chairman David S Ruder).

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Second, the theory is consistent with common law principles and the statuary language of r 10b-5. Finally, in practice, almost all of the countries with insider trading prohibition, except the United States, have soundly adopted the equality of access theory and, even in the United States, the SEC has been trying hard to resurrect the theory.

(1) Advantages of the equality of access theory

From a practical perspective, the equality of access theory is preferable to other alternative theories. For one thing, the equality of access theory is theoretically sounder than the fiduciary-duty-based theories. As discussed before, the fiduciary-duty-based theories suffer serious problems and have significant loopholes. Indeed, because the equality of access theory is not based on the notion of fiduciary relationship, and instead recognises that a party has a duty to disclose if he or she has access to information which is not legally available to the other party, it closes the gaps in the fiduciary-duty based theory.

More specifically, while the classical theory may fail to account for a vast number of insider trading cases where insiders sell stock to prospective shareholders, and where non-equity securities are traded,[170] the equality of access theory would easily handle them; although non-fiduciary misappropriators, and brazen fiduciaries would all escape liabilities under the misappropriation theory,[171] they would be held accountable under the equality of access theory. Thus, the equality of access theory would punish equally culpable behaviour in a consistent manner. Regardless of an individual's status as an insider, quasi-insider, tippee or outsider, trading securities on the basis of material non-public information is equally culpable from the perspective of investors. Indeed, the harm to investors comes from the objective use of illegitimate information advantages by those with whom they trade. To premise investor protections on any other things, such as the breach of fiduciary duties between traders as required by the classical theory, the deception of the source of information as required by the misappropriation theory, is not only illogical but also contrary to the goal of investor protection.

Moreover, compared to the fiduciary-duty-based theories, the equality of access theory is conceptually more straightforward and technically easier to apply. Indeed, by adhering to a fiduciary relationship, the fiduciary-duty-based theories unduly complicate an already complex area. Under the fiduciary-duty-based theories, one has to make many vexing inquiries. For instance: is there a fiduciary duty present? What type of relationship is deemed to be fiduciary or one of trust and confidence? Who is a temporary-insider and under what circumstances? What constitutes a 'personal benefit' for tipping liabilities to attach? What must be established for there to be misappropriation of the subject information? By contrast, the equality of access theory rests on the notion of fairness, and the only question one needs to ask is whether one party to a transaction enjoys unequal access to inside information.

In addition, the equality of access theory focuses on the access to information rather than the information itself, which renders it essentially different from the parity of information theory which has a fatal problem.

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170 See Part IV(B)(1).
171 See Part IV(B)(1).

Under the parity of information theory, all information, public or non-public, held by one party must be disclosed to the other party. Put differently, this theory condemns any transaction in which one party possesses information unknown to the other side. The weakness of this theory is that it would discourage legitimate and desirable information gathering efforts. Indeed, information often takes work to produce and thus there should be some reward to encourage the production of information. An equal information rule could undermine the incentives to search for valuable information for trading stock.[172] Thus, the parity of information theory clearly contradicts with the business reality that almost all securities trading permit certain types of informational advantages, such as those that come from differences in diligence or intelligence. For this reason, no nation follows this theory.

In contrast, the equality of access theory ensures equal access to information. Under this theory, trading becomes unfair if one party has access to information unknown to another. To be sure, equal access to information does not mean equal information because the equality of access theory does permit legitimate information production. As Justice Blackmun stated in his dissenting opinion in *Chiarella*:

> there is a significant conceptual distinction between parity of information and parity of *access* to material information. The latter gives free rein to certain kinds of information advantages that the former may foreclose, such as those that result from differences in diligence or acumen.[173]

Professor Brudney has further developed the equality of access theory, arguing that unequal access to material, non-public information is unfair because it can generate 'unerodable' informational advantages that no amount of insight, luck, or diligent research can overcome.[174] Thus, the equality of access theory is free from the parity-of-information-related concern that the incentives to produce information would dry up.

(2) Common law principles

The equality of access theory is not only practically desirable, but also theoretically justifiable. As discussed before, the equality of access theory creates a general duty for those market participants who have superior access to confidential material information that is not *legally available* to others. This duty was rejected by the US Supreme Court on the grounds that it is contrary to 'the established [common law] doctrine that duty arises from a specific relationship between two parties'.[175] Thus, in deciding whether the duty under the equality of access theory is really in contradiction with common law, it is to the common law that we must first turn.

Under common law, a valid cause of action for fraud must include the

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172 See, eg, F H Easterbrook, 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information' (1981) 1981 *Sup Ct Rev* 309 at 329–30: 'if information must be equalized, there will be precious little to go around'; K E Scott, 'Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy' (1980) 9 *J Legal Stud* 801 at 812: 'a requirement of free disclosure destroys incentives to *produce* information'.

173 *Chiarella v United States* 445 US 222 at 252 n 2 (1980) (Justice Blackmun dissenting).

174 V Brudney, 'Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law' (1979) 93 *Harv L Rev* 322 at 354–5.

175 *Chiarella v United States* 445 US 222 at 233 (1980).

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following elements: (1) a false or misleading statement of fact; (2) made with knowledge of its falsity; (3) intended by the marker to induce the listener's reliance; (4) which justifiably induces such reliance; and (5) damages were incurred by the listener.[176] In general, an affirmative statement is required for a plaintiff to bring a fraud action, and mere nondisclosure, by itself, is not enough. This rule was derived from the principles of 'caveat emptor'.[177] However, there are a limited number of exceptions to this general rule. In other words, in certain circumstances, a defendant's 'pure silence' may also constitute fraudulent conduct.

One such circumstance occurs when there is a fiduciary relationship between the parties to a transaction. The fiduciary relationship contains such a degree of trust that a party can justifiably rely on his or her fiduciary to bring all significant facts to his or her attention. Consequently, a party has a duty to disclose matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. The court developed the classical theory of insider trading liability precisely on the basis of this exception: absent a fiduciary duty, or one derived from it, a party to a transaction has no duty to disclose.

However, the problem with the classical theory is that it seems to suggest that the above circumstance is the *only* exception to the general rule. Justice Blackmun, in his dissenting opinion, correctly stated:

> I, of course, agree with the Court that a relationship of trust can establish a duty to disclose under § 10(b) and Rule 10b-5. But I do not agree that a failure to disclose violates the Rule *only* when the responsibilities of a relationship of that kind have been breached.[178]

Indeed, there are several other well-recognised exceptions to the general rule. Other situations where an affirmative duty to disclose may arise include: (1) when one party actively conceals information from another party; (2) when one party's previous once-true statement has become materially misleading in light of subsequent events; (3) when one party makes a half-true or ambiguous statement; and (4) when one party has special facts which are not discoverable upon reasonable inspection by the other party.[179] The last category — undiscoverable facts upon reasonable inspection — is most relevant to the issue whether a duty to disclose arises from unequal access to information,

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176 W Page Keeton et al, *Prosser and Keeton on the Law of Torts*, 5th ed, West Group, 1984, p 728.

177 Ibid, p 737; W Page Keeton, 'Fraud, Concealment and Nondisclosure' (1936) 15 *Tex L Rev* 1 at 5: 'the whole doctrine of *caveat emptor* . . . resulted primarily from the individualistic attitude of the common law in its early stages'.

178 *Chiarella v United States* 445 US 222 at 247 (1980) (Blackmun J dissenting) (emphasis added). Many commentators have criticised the court's disregard for other exceptions to the general rule. See, eg, A Grey Anderson, 'Fraud, Fiduciaries, and Insider Trading' (1982) 10 *Hofstra L Rev* 341 at 351; D C Langevoort, 'Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement' (1982) 70 *Cal L Rev* 1 at 12.

179 W Page Keeton et al, *Prosser and Keeton on the Law of Torts*, above n 176, pp 737–40; J Fleming Jr and O S Gray, 'Misrepresentation — Part II' (1978) 37 *Md L Rev* 488 at 523 (explaining several exceptions to the general rule that there is no affirmative duty to disclose between parties dealing at arm's length); N W Palmieri, 'Good Faith Disclosures Required During Precontractual Negotiations' (1993) 24 *Seton Hall L Rev* 70 at 120–41 (discussing a variety of circumstances under which the general rule is inapplicable).

because insider trading cases premised on the equality of access theory involve the use of 'unerodable' informational advantages that reasonable inspection cannot overcome.

The rationale of the 'special facts' exception is clear. If facts are discoverable upon reasonable inspection, the party with knowledge of those facts has no duty to disclose to the other party. The purpose of this rule is to encourage parties to seek out and benefit from legitimate information advantages, such as by deliberate search. It is fair game for more information because the information is legally available to both parties. However, this is not true when the information is undiscoverable upon reasonable inspection to other party. It is simply unfair to punish the other party for failing to discover the information which is undiscoverable. Worse, it would be a sorry story if one can keep silent and profit from illegitimate information advantage. This may actually encourage people to acquire information advantages through wrongful or even illegal means.[180]

The 'special facts' exception has been embraced by the US Restatement (Second) of Torts. According to s 551(2)(e) of the Restatement of Torts, a party has a duty to disclose:

> facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.[181]

Similarly, the law of contract also recognises a duty to disclose on the part of a party with information which is not legally discoverable.[182] In a securities transaction which is essentially a contract to trade stock, there exists a basic assumption that both parties have equal access to information.[183] Thus, if one party has unequal access to a fact that the other could not possibly know by reasonable inspection, he or she must disclose that fact.

In sum, to the extent that the 'special facts' doctrine has already been accepted by common law, the argument loses its force that a duty to disclose arises *only* when there is a fiduciary relationship between trading parties. Rather, there is a duty to disclose on the part of a party who has unequal access to facts which are not legally available to the other party. This provides a very compelling case for the equality of access theory under which trading securities on the basis of undisclosed information is viewed as a fraud against those who cannot discover the information upon reasonable inspection.

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180 For an analysis of the existence of disclosure duties where the information advantages were unlawfully obtained, see D M Nagy, 'Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan* Suggestion' (1998) 59 *Ohio St LJ* 1223 at 1289–92.

181 Restatement (Second) of Torts § 551(2)(e) (1979).

182 Restatement (Second) of Contracts § 161(b) (1979). In pertinent part, it provides that:

> A person's nondisclosure of a fact known to him is equivalent to an assertion that the fact does exist . . . where he knows that disclosure of the fact would correct a mistake of the other party as to a basis assumption on which that party is making the contract and if nondisclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

183 R F Kidd, 'Insider Trading: The Misappropriation Theory versus An "Access to Information" Perspective' (1993) 18 *Delaware Jnl of Corp L* 101 at 130.

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(3) The widespread acceptance of the equality of access theory

In practice, the propriety of the equality of access theory has been confirmed by the widespread acceptance of the theory worldwide. Interestingly enough, while the equality of access theory was discarded by the United States, it has thrived elsewhere in the world. Although many nations have followed the United States' lead to prohibit insider trading, they have soundly rejected the fiduciary-duty-based theories on which the current US insider trading law is based, and have instead chosen the equality of access theory to establish their insider trading regimes.[184] For instance, the United Kingdom, France, Germany, Italy, (Ontario) Canada, Mexico, Japan and Australia have basically all adopted the equality of access theory.[185]

This international trend is not a chance event but instead suggests that, from a practical viewpoint, the equality of access theory can more effectively support insider trading liability. This has led one US commentator to observe that:

> Australia's experience with an equal access rule might prove that from a policy perspective, there may have been no reason for the [US] Supreme Court to reject the equal access approach in *Chiarella*.[186]

Support for the equality of access theory is not only found in jurisdictions outside the United States, but also within the United States. Indeed, the theory has received both official and academic support within the United States. Even though the equality of access theory has been clearly rejected by the US Supreme Court, the SEC has never given up its efforts to restore the theory as much as it can. Indeed, the SEC, acting ostensibly within its rulemaking authority, has sought to minimise restrictive Supreme Court law. For instance, the SEC promulgated r 14e-3 in the tender offer context on the basis of the equality of access theory.[187] Another example is reg FD which seeks to

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184 M I Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *Uni of Pennsylvania Jnl of International Economic Law* 635 at 667 (stating that 'many countries opt for an insider trading proscription premised on the "access" doctrine').

185 Ibid, at 667–8; see also F A Gevurtz, 'The Globalization of Insider trading Prohibitions' (2002) 15 *Transnational Lawyer* 63 at 77 (discussing the adoption of the equality of access theory by Australia and the EU Directive); E Ruggiero, 'The Regulation of Insider trading in Italy' (1996) 22 *Brook J Int'l L* 157 (concluding that Italy adopts an equal access approach); T Akashi, Note, 'Regulation of Insider Trading in Japan' (1989) 89 *Colum L Rev* 1296 at 1312–13 (stating that the Japanese law of insider trading 'is premised on the traditional notion of "unfairness"' and 'will reach persons with a duty to disclose information or to abstain from trading simply because they know that they possess certain material non-public information').

186 Gevurtz, ibid, at 97.

187 17 CFR § 240.14e-3 (1997). Rule 14e-3 prohibits trading by any person in possession of material, non-public information relating to a tender offer when the person knows or has reason to know that the information is non-public and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. Under r 14e-3, a fiduciary relationship between traders as required by the classical theory is irrelevant for insider trading liability to attach. Thus, with r 14e-3, the SEC actually applies the equality of access theory in the tender offer setting where much if not most of insider trading is seen. For more discussion of this issue, see, eg, Loss and Seligman, above n 70, pp 3729–39; D C Langevoort, *Insider Trading: Regulation, Enforcement, and Prevention*, looseleaf, West Group, § 7.05.

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prohibit company selective disclosure, a practice closely resembling insider tipping.[188] Moreover, many prominent academics, including Professor Brudney and Dean Seligman, have advocated the equality of access theory.[189]

V The definition of insider: the Australian 'information connection only' approach

As discussed above, China's statutory definition of insiders is unduly complicated and may facilitate schemes to evade the law. In view of the complexity of insider trading, such a legislative approach to the definition of insiders is essentially problematic and any rigidity of the definition would result in ineffectiveness of the law. To remedy this problem, it is advisable that China adopt the 'information connection only' approach as employed by some countries, most notably Australia.[190]

A. The strengths of the Australian approach

In Australia, under s 1043A of the Corporations Act, an insider is any person who possesses information and who 'knows or ought reasonably to know' that the information 'is not generally available' and 'might have a material effect on the price or value' of securities.[191] Insiders are defined solely according to their possession of relevant inside information. The additional 'person connection' requirement is not applied.[192] Under this 'information connection only' approach, there is no need to distinguish between primary and secondary insiders (tippers/tippees). Clearly, if the 'information connection' test is stratified, it makes no difference how, or from whom, the person has obtained the information.

Thus, the definition of insider covers all persons who knowingly obtain inside information, even by chance.[193] This approach would effectively overcome the loopholes that currently exist in the Chinese insider trading law. Individuals who are not explicitly listed in Art 68 of the Securities Law but who are in possession of inside information, such as, (as discussed earlier) retired corporate directors or officers, other governmental officials, and their tippees, would be held liable for trading on inside information.

This 'information connection only' approach is inherently consistent with the equality of access insider trading theory. As discussed previously, the

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188 See Part IV(B)(1).

189 See, eg, V Brudney, 'Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law' (1979) 93 *Harv L Rev* 322 at 376 (proposing a ban on trading based on 'unerodable informational advantages'); J Seligman, 'The Reformulation of Federal Securities Law Concerning Nonpublic Information' (1985) 73 *Geo L J* 1083 at 1137–8 (suggesting a general prohibition on trading while in possession of material, nonpublic information, with certain exceptions, such as exempting potential takeover bidders from the disclose or abstain rule).

190 A number of countries such as Singapore and Malaysia have followed the Australian approach. See Corporations and Markets Advisory Committee (Australia), *Insider Trading Discussion Paper, June 2001*, s 1.64 n 88.

191 Corporations Act (Cth) s 1043A.

192 For a description of the 'person connection' requirement, see Part III(A).

193 Corporations and Markets Advisory Committee (Australia), *Insider Trading Discussion Paper June 2001*, s 1.62.

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equality of access theory focuses on whether the market provides a level playing ground, whether any party to a transaction has unequal access to material non-public information and does not require any other tests, such as the existence of fiduciary duty, as a prerequisite for liability to attach. In accordance with this, the 'information connection only' approach defines insiders merely by reference to their possession of inside information, making it irrelevant whether the perpetrator has some direct or indirect connection with the company whose securities are traded.

Indeed, it is the use of inside information, not a person's connection with the company whose securities are traded or some other entity, which can harm the market. From the perspective of market fairness and efficiency, it can be difficult to justify the additional 'person connection' requirement, such as the fiduciary relationship and the employment relationship, that would allow insider trading activities to be carried out by some persons armed with inside information.[194] As argued before, China should adopt the equality of access theory, which paves the way for the adoption of the 'information connection only' approach.

Further, this approach is more conceptually straightforward and thus assists market participants to better understand insider trading law. Historically, Australia applied the additional 'person connection' test before 1991. This approach was abolished in 1991 after it received severe criticism regarding the technicalities and potential gaps in the definition of insider. It was held that 'the prohibition requiring the person to be connected to the corporation which is the subject of the information unnecessarily complicates the issue'.[195] Indeed, as discussed earlier, it is difficult to apply the 'person connection' test.[196] Under the 'information connection only' approach, the whole insider trading regime can be established with simplicity and certainty. As pointed out by one commentator:

> Nothing more needs to be said other than that an insider is a person in possession of insider information. In other words, the definitional burden in the legislation should fall on deciding what is inside information and the definition of insider should follow as a secondary consequence of this primary definition . . . The proposal that insiders should be defined as those in possession of insider information would to some extent reduce uncertainty, because the only question that would have to be asked is whether the individual was in possession of inside information and the additional question of whether the individual met the separate criteria for being classed as an insider would be irrelevant.[197]

B. Concerns with the Australian Approach

Although the 'information connection only' approach can bring simplicity and inclusiveness to insider trading law, there are concerns about its possible over-breadth. From a comparative perspective, this approach has been deemed

194 Ibid, s 1.73.

195 Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs (Australia), *Fair Shares for All: Insider Trading in Australia*, 11 October 1990, para 4.3.5.

196 See text accompanying n 69.

197 *Gower's Principles of Modern Company Law*, 6th ed, Sweet & Maxwell, 1997, pp 464–5.

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to be one of the broadest in the world, and is described as 'expansive',[198] 'extraordinarily broad',[199] and 'unusually broad'.[200] This is readily understandable because it is easy to get such an impression at first blush. In contrast to the US approach under which the insider trading prohibition begins with a narrow classical theory and then expands to the misappropriation theory,[201] the Australian approach is broad from the outset and then gradually narrows down its scope. In order to prevent the approach from being reduced to the parity of information theory,[202] Australia has taken a number of important measures, such as limiting the scope of inside information,[203] carving out some particular exceptions,[204] and so on. Thus, the Australian law effectively sticks to the equality of access theory in the sense that people with an informational advantage, if discovered by research or legitimate means, would not be exposed to liability.[205]

Indeed, although the Australian approach may look very broad, no solid evidence has been presented so far to suggest that it is in fact too broad or over-inclusive. This should not be surprising because, as discussed above, the theoretical basis of the approach is sound and by defining inside information or carving out exceptions one could — as Australia has done — readily deal with possible over-breadth therein. Recall the example quoted earlier: an employee who has no right of access to inside information in his or her position but hears, by chance, of that information while at work.[206] This scenario is clearly covered by the Australia prohibition, which may serve as a good example that the Australia approach is too broad. However, this example is not convincing because the employee would be caught under other approaches as well.

For example, under the EU Insider Trading Directive, it is possible that the employee would be treated as a primary insider.[207] Even assuming that under a strict interpretation of the 'by virtue of employment' requirement, it may be

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198 M I Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *Uni of Pennsylvania Jnl of International Economic Law* 635 at 668.

199 F A Gevurtz, 'The Globalization of Insider trading Prohibitions' (2002) 15 *Transnational Lawyer* 63 at 67.

200 Interview with Professor Donald C Langevoort, 19 July 2002, University of Sydney, Australia.

201 See Part IV(A)(2).

202 Indeed, the broadness of the Australian approach has led some commentators to say that Australia has adopted the parity of information theory. See, eg, M I Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *Uni of Pennsylvania Jnl of International Economic Law* 635 at 668.

203 Australian law excludes deductions, conclusions or inferences made from publicly available information from the scope of inside information, and thus eliminates the danger of discouraging legitimate information gathering. See Corporations Act 2001 (Cth) s 1042(1)(c).

204 For example, Australia makes exceptions for knowledge of person's own intentions or activities, and thus the acquiring company can safely enter into the transaction with the knowledge of its intent to make a premium price tender offer for stock in the target corporation: Corporations Act 2001 (Cth) s 1043H.

205 For comparison of the equality of access theory and the parity of information theory, see Part IV(B)(2).

206 See text accompanying n 69.

207 Ibid.

successfully argued that the employee cannot be a primary insider, he or she would not escape liability as a secondary insider (tippee) because the inside information was directly or indirectly received from a primary insider.[208] Hence, the employee would be held liable in any event under the EU Insider Trading Directive. Moreover, whether the employee is treated as a primary insider or a secondary insider is irrelevant because either violation, as a primary insider or as a secondary, carries the same penalty.[209]

From other perspectives, some commentators have voiced their concerns as to the Australian 'information connection only' approach. It has been argued that the EU Insider Trading Directive is preferable over the Australian law because there are 'uncertainties' under the Australian law.[210] This commentator, however, did not go further to point out what the uncertainties are, which greatly reduces the force of his assertion. On the contrary, as discussed above, certainty is precisely one of the advantages of the Australian approach.

Another more reflective concern is that under the Australian approach, the regulators' image may be at risk to the extent that due to resource constraints, regulators would be unable to catch all insider trading activities covered by the broad law.[211] On this view, the Australian approach is too broad, not because some of the activities that are covered are not theoretically punishable but because as a practical matter, regulators cannot possibly catch them, thereby jeopardising their reputation. The major merit of this argument is that legislation should be drafted in a realistic way to ensure effective enforcement, and regulators should devote their limited resources to deal with more common or serious breaches. Indeed, it is meaningless or even harmful to make laws that are doomed to be unenforceable.

However, this argument may not be strong enough to negate the Australian approach. Firstly, it does not rebut the theoretical case for the Australian approach. Society would not narrow down the scope of laws prohibiting murder if, due to limited resources, police could not successfully detect every murder case. For example, it would be less than sensible to provide that the criminal law only cover egregious murder cases. In this sense, this argument seems to be a variant of the untenable argument that because the enforcement of insider trading law is costly and ineffective, insider trading should not be regulated.[212]

Secondly, it is doubtful whether the enforcement problem would significantly damage a regulator's reputation. It has been argued that all rules are inherently over-inclusive and thus need flexible application.[213] As a matter of fact, whether in Australia or elsewhere, including the United States which adopts a more restrictive approach, regulators all face the problem of

208 Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing, 1989 OJ (L 334) 30, Art 4.
209 Ibid.
210 F A Gevurtz, 'The Globalization of Insider Trading Prohibitions' (2002) 15 *Transnational Lawyer* 63 at 78.
211 Interview with Professor D C Langevoort, 19 July 2002, University of Sydney, Australia.
212 See, eg, Loss and Seligman, above n 70, p 3466 n 38 (refuting the argument against insider trading regulation).
213 See, eg, J Black, *Rules and Regulators*, Oxford University Press, 1997, pp 27–9.

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enforcing insider trading laws and are inevitably and necessarily selective in deploying their resources. Thus, the enforcement problem is nothing new to insider trading, nor peculiar to the Australian approach.

Conclusion

Based on the ideas of a range of foreign sources, notably the United States, China has made rapid progress in establishing its insider trading regime. There are, however, some serious problems with the Chinese law, due to the uncritical implantation of overseas experience. This is strikingly illustrated by the loopholes found in the definition of insider which are inherently related to the confusion around the underlying theory of insider trading liability.

It appears that China has hastily imported two conflicting insider trading theories, namely the equality of access theory and the fiduciary-duty-based theories which include the classical theory and the misappropriation theory. A careful analysis reveals that the fiduciary-duty-based theories, as adopted by the current US insider trading law, suffer several troublesome problems and more importantly are not suited to local Chinese conditions. In contrast, the equality of access theory, as adhered to by many other countries, seems to be more appropriate for China. It is further suggested that the Australian 'information connection only' approach is both theoretically justifiable and practically manageable and, thus, is worthy of serious consideration for the purposes of reforming the regulation of insider trading in China.