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Charles Zhen Qu

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AN OUTSIDER'S VIEW ON CHINA'S INSIDER TRADING LAW

Charles Zhen Qu[†]

Abstract: China's insider trading law can be found in the country's first unified securities industry law, *Securities Law of the People's Republic of China*, which came into force on July 1, 1999. The provisions of this law relating to insider trading, however, do not seem to help achieve the legislative purpose of the Securities Law, namely, to protect the interest of investors and promote the development of a socialist economy. The inadequacy of the current regime lies in the overly narrow definitions of "insider" and "inside information," the lack of workability of civil liability provisions, and the failure of China's Securities Regulatory Commission to use its interpretive powers. This Article argues that these problems can be solved by adopting Australia's approach to insider trading regulation, which is based upon a person's ability to access non-public material information.

I. INTRODUCTION

An effective financial market is essential to China's successful transition from the old planned economy to a market orientated economy. It is also vital to China's successful integration into the world market and the World Trade Organization ("WTO"). To ensure the efficacy and integrity of its financial market, China enacted its first unified securities legislation, the *Securities Law of the People's Republic of China* ("Securities Law").[1] The Securities Law was drafted with guidance from the United States,[2] and was enacted on December 29, 1998. The purpose of the new law is to standardize the issuing and trading of securities, to protect the lawful rights and interests of investors, to safeguard the social and economic order and public interests, and to promote the development of the socialist market economy.[3]

This Article examines the likely efficacy of the insider trading provisions introduced under the Securities Law and considers possible options to improve its workability, including the adoption of Australia's

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[†] B.A., East China Normal University (1984); Graduate Diploma in Information Management, University of New South Wales (1990), LL.B. University of New South Whales (1990); GDLP, The College of Law (New South Wales) (1998); S.J.D. candidate University of New South Wales; Associate Lecturer, Griffith University Faculty of Law.

[1] Zhonghua Renmin Gongheguo Zhengquanfa [Security Law of the People's Republic of China] (promulgated Dec. 29, 1998, effective July 1, 1999) (P.R.C.) [hereinafter Securities Law].

[2] Minkang Gu & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 117 (1996).

[3] Securities Law, *supra* note 1, art. 1.

insider trading law. Australia's insider trading regime is based on a person's ability to access non-public material information. This is distinguishable from U.S.-originated fiduciary duty and misappropriation theories, which are both based on common law fiduciary principles.[4] This Article concludes that it would be easier for Chinese lawyers to adopt a legal approach that is not based on common law equity doctrines. Part II considers the policy justifications for regulating insider trading activities in China. Part III traces the development of China's current capital markets and insider trading law. Part IV examines the efficacy of the insider trading provisions under the Securities Law, and Part V suggests possible options to remedy inadequate provisions in the current regime.

II. JUSTIFICATIONS FOR PROHIBITING INSIDER TRADING ACTIVITIES IN CHINA

Insider trading has been defined as "trading by a trader who possesses information that is 'material' to the price of the securities which are traded, [and] which is not already known to other traders in the market."[5] In other words, insider trading refers to trading activities by a person who possesses non-public information that will affect the price of the securities in question. Such information can be classified as "good news" or "bad news." For example, a person possessing non-public information regarding a pending hostile takeover commits insider trading by purchasing shares of the target company *before*, and selling the shares *after*, the public announcement of the takeover is made. The information traded on in this example is "good news," since hostile takeovers typically raise the share price of target companies.[6] However, an insider, meaning an individual in possession of material, non-public information about a company, can also trade on "bad news." An insider who sells shares prior to the release of news about poor corporate earnings or about the defection of a key employee to a competitor is said to have traded on "bad news," because such information can negatively impact the price of the given stock.[7]

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[4] *See* Michael Gething, *Insider trading Enforcement: Where Are We Now and Where Do We Go From Here?*, 16 COMPANY & SECURITIES L. J. 607, 608-09 (1998).

[5] Ashley Black, *The Reform of Insider Trading Law in Australia* 15(1) UNIV. N.S.W. L. J. 214, 214 (1992).

[6] For example, in United States v. O'Hagan, 521 U.S. 642 (1997), a lawyer who traded securities on non-public information about a pending takeover by one of his law firm's corporate clients was convicted of insider trading.

[7] The release of "bad news" can have a dramatic impact on the price of a stock. For example, AXA Asia-Pacific's shares fell more that five percent on August 17, 2000 in response to an announcement concerning the defection of key financial planning agents from the company's Hong Kong operation to a

It is necessary to prohibit insider trading activities in China for two practical reasons. First, in order to attract foreign investment, China must make overseas investors feel confident about the integrity of China's financial market. Insider trading is often associated with other forms of abusive trading activities, such as market manipulation and short selling. Potential investors will likely lose interest in China's financial market if it is riddled with activities that hurt investor's interests and are prohibited in other financial markets. Second, insider trading activities cause actual financial damage to the Chinese securities market. Potential victims of an insider trading racket span the entire breadth of the market and such widespread loss can damage the market as a whole.[8] For these reasons, insider trading should be prohibited in China.

A. Insider Trading and Investment from Overseas

China's economic reform, especially the reform of the state-owned sector, depends on the availability of liquid capital.[9] With China's imminent entry into the WTO, China will be able to attract investment from overseas, as the country's financial markets will be open to foreign investors. A financial market riddled with fraud, real or perceived, such as insider trading and market manipulation will deter investors from countries where there is a higher degree of market integrity. China's entry into the WTO is conditioned upon implementing a broad range of market-opening reforms.[10] The fact that WTO members imposed such a condition demonstrates the extent of overseas investors' concern about market integrity in China. Failing to prohibit insider trading will dissolve foreign investors' confidence in the integrity of China's financial markets and limit the market's ability to attract investment from overseas.

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company competitor. Sean Aylmer, *Axa Shares Tumble After Hong Kong Agents Defect to Competitor* AUSTL. FIN. REV., Aug. 18, 2000, at 59.

[8] For example, during the 1980s, Dennis Levine and Ivan Boesky were two of the most notorious inside traders on Wall Street. They both made their fortune by relying almost exclusively on insider information provided by an extensive network of informants. *See* JAMES B. STEWART, DENS OF THIEVES 68-94 (1991); FENTON BAILEY, THE JUNK BOND REVOLUTION: THE USA, UK AND JAPAN 132-46 (1992). The damage done to the securities market can be gauged by the $100 million Boesky was ordered to return. MICHAEL MORAN, THE POLITICS OF THE FINANCIAL SERVICES REVOLUTION 47 (1991).

[9] F. Dong, *Developing Capital Markets and Reforming State-Owned Enterprises*, *in* THE THEORY AND PRACTICE OF THE DEVELOPMENT OF CHINA'S CAPITAL MARKETS 109 (Y. Li et al. ed., 1998).

[10] Michael Dwyer, *China Speeds up Plans to Open Markets to Foreigners*, AUSTL. FIN. REV., June 28, 2000, *available at* 2000 WL 20845282.

B. *Insider Trading and Other Forms of Abusive Trading Activities*

Insider trading is often associated with market manipulation. Market manipulation refers to practices "designed to stimulate artificially market turnover and share prices for the purpose of profiting, at the general public's expense, from the distortions inflicted on the market."[11] Market manipulators typically trade inside information to create artificial market turnovers and false share prices.

Market manipulation is particularly prevalent in China. The 1997-1999 issues of *China Securities Regulatory Commission Official Bulletin* contain reports of at least seven serious cases of market manipulation.[12] Market manipulations typically occur as follows: a corporate entity opens a number of accounts under different aliases; next, it subscribes for a large number of shares in a company; finally, the shares are sold from one account to another, thereby artificially raising the stock's turnover and share price.

In each case reported in the 1997-99 Official Bulletin, manipulation activities were coupled with insider trading activities. When the price of the manipulated shares was raised to a certain level, those involved would sell their shares and reap huge profits. However, once the manipulators sold their shares, the price of the stock would plummet, resulting in significant losses for the uninformed investors.

Alternatively, a company can manipulate the price of its own shares by forming an alliance with another company and trading on inside

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[11] Senate Select Committee on Securities and Exchange, Australian Securities Markets and their Regulation, Report (AGPS, Canberra, 1974), at 207, *in* ROMAN TOMASIC & STEPHEN BOTTOMLEY, CORPORATIONS LAW IN AUSTRALIA 683 (1995).

[12] *See* Decision of the China Securities Regulatory Commission ("CSRC") on the punishment of Guangfa Securities Co. for breaching the securities law and regulations (June 11, 1997), 16 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 77 (Aug. 1997) (P.R.C.); CSRC's decision on the punishment of Shenyin Wanguo Securities Co. Ltd. for breaching securities law and regulations (June 11, 1997), 17 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 79 (Aug. 1997) (P.R.C.); CSRC's decision on the punishment of Haitong Securities Co. for breaching securities law and regulations (June 11, 1997), 18 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 81 (Aug. 1997) (P.R.C.); CSRC's decision on the punishment of Nanshan Fund Management Co. for breaching securities law and regulations (June 11, 1997), 20 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 85 (Aug. 1997) (P.R.C.); CSRC's decision on the punishment of Hunan Huatian Enterprise Group Co. and Shenzhen Weishen Securities Co. for breaching securities law and regulations (Apr. 14, 1998), 21 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 47 (Apr. 1998) (P.R.C.); CSRC's decision on the punishment of Zhongyuan (Shanghai) Zhiye Development Co. Ltd. for breaching securities law and regulations (Apr. 21, 1998), 23 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 49 (Apr. 1998) (P.R.C.); CSRC's decision on the punishment of Nanfang Securities Co. Ltd., Beida Chehang Co. Ltd. and other institutions and individuals for breaching securities law and regulations (Oct. 7, 1999), 28 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 47 (Dec. 1999) (P.R.C.); CSRC's decision on the punishment of the Constructive Group of Liaoning Province, Liaoning Jindi Construction Ltd. Group and Guangfa Securities Co. Shanghai Office for breaching securities law and regulations (Oct. 11, 1999), 29 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 50 (Dec. 1999) (P.R.C.).

information. In such situations the insiders profit at the expense of parties who trade with them. In *Nanfang Securities and Bei Da Che Hang*[13] the issuing company Bei Da Che Hang ("BDCH") tipped Nanfang Securities, an underwriter, about the impending allotment of newly issued shares to existing holders at no charge.[14] The underwriter then acquired a large number of BDCH shares. Through cooperation between Nanfang and BDCH and a third party, the share price rose by almost 100% in the course of the share allotment. At the conclusion of the operation, Nanfang sold all their acquired shares, making a net profit of RMB 77,418,900 (about U.S. $9,441,300), which was shared with Nanfang Securities and its holding company Nanfang Group.

Insider trading associated with market manipulation and other forms of abusive trading activities can have a damaging impact on a region's economy. Indeed, the massive speculative double play by hedge fund managers in Hong Kong in 1998 illustrates this phenomenon. Hedge fund managers sold Hong Kong dollars heavily, then spread rumors in the market that the Hong Kong dollar's fixed exchange rate with the U.S. dollar was about to be abandoned. The purpose of this move was to force a defensive interest rate hike. At the same time, the Hong Kong shares were sold short on the assumption that the rate hike would force stock prices down.[15] Had the hedge funds maneuver been successful, interest rates would have been elevated to an artificial level, investments in the financial market would have been diverted to other sectors of the economy, and share prices would have been pushed down. This scheme would have enabled the manipulators to make a fortune on using other people's money. Fortunately, the maneuver was not successful because the Hong Kong government learned about the plan and spent $23 billion over the course of eleven days on all 33 stocks in the Hang Seng index to sustain the stock prices and force the retreat of the fraudulent investors.[16]

The techniques used by the hedge fund players included market manipulation (by selling Hong Kong dollars heavily and spreading false rumors), short selling, and insider trading. The information at issue in the Hong Kong hedge fund scandal was inside information because the

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[13] Nanfang Securities & Bei Da Che Hang, 10 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 47 (1999) (P.R.C.).

[14] This practice is called "Song Gu" and is quite prevalent in China. The price of the shares will often drop following a Son Gu, because Son Gu can be made from both company profits and the issuing company's capital reserve. JIAREN JU, ZHENJUANFA WUSHI DAODU 350 TI [A SECURITIES LAW PRACTICE GUIDE: 350 QUESTIONS] 133 (Beijing 1999).

[15] Steve Burrell, *The Man Who Saved Hong Kong*, SYDNEY MORNING HERALD, Aug. 4, 2000, at 24.

[16] *Id.*

managers' manipulation of the market was not public knowledge. Short selling refers to "[t]he sale of a security that is not yet owned, in the expectation that its price will fall so that it can be bought back later at a profit."[17] For example, a fund manager may briefly borrow shares from an investor for a fee to short-sell the shares. If the price of the shares falls after the sale, the fund manager may buy the shares back and return them to the lender so the manager makes a profit.[18]

The trading volume and liquidity of China's financial market are both very low, making China's market more susceptible to manipulation than the markets in most other countries. State-owned securities, which account for 70% of the country's issued shares, are not negotiable in China's financial markets for ideological reasons.[19] Therefore, a prohibition against insider trading, which is often associated with other forms of abusive activities such as market manipulation and illegal short selling, bears particular relevance to the protection of the financial market and investors' interests in China.

III. THE BACKGROUND OF CHINA'S INSIDER TRADING LAW

A. *The Development of the Current Capital Markets*

China's modern financial markets developed in the 1980s, following the Communist Party's decision to transform the planned economy into a socialist market economy. A form of the market economy emerged in the rural sector after the third plenary session of the 11th National Congress in 1978. Before 1978, the basic unit of the productive force was what was called "team of production." A team, normally composed of rural villagers, produced what the central government mandated. Since 1979, teams of production[20] have been able to contract out tasks of production to individual farmers. In general, privatization in the rural sector has helped to increase

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[17] *See* Australian Financial Review Dictionary of Investment Terms, County Investment Management, *at* http://www.county.com.au/web/webdict.nsf/pages/index.

[18] *See* Barrie Dunstan, *Retail Investors Can Sell Themselves Short*, AUSTL. FIN. REV., Sept. 8, 2000, *available at* 2000 WL 26256076.

[19] If state-owned securities were negotiable in the market it would be possible to transfer the state-owned securities to private hands. That would deviate from the constitutional provision that the means of production is owned by the whole people, and the State. ZHONGHUA RENMIN GONGHEGUO XIANFA [CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA] (adopted Dec. 4, 1982, amended Apr. 12, 1988, Mar. 29, 1993, Mar. 15, 1999) (P.R.C.) [hereinafter P.R.C. CONST.], art. 6. In other words, negotiability of state-owned securities will convert state-owned enterprises to private enterprises. This will turn China from a socialist country into a capitalist country. *See* F. Cao, *Capital Reorganization for Enterprise and Capital Market*, in Zhongguo Ziben Shichang Fazhan De Lilun Yu Shijian [THEORY AND PRACTICE OF THE DEVELOPMENT OF CHINA'S CAPITAL MARKET] 141, 154 (Y. Li. et al. eds., Beijing 1998).

[20] Teams of production were called "Cun," which means village.

the efficiency of farming activities, which in turn, created a considerable surplus of rural labor and encouraged the establishment of small manufacturing business entities in the rural sector.

China was still largely a planned economy when the number of small rural manufacturing businesses mushroomed. For this reason, it was nearly impossible for these businesses to obtain loans from banks owned by the State. This meant that there was a need for funding to enable these businesses to operate. Consequently, funding was achieved by the issuance of writs similar to debentures. This constituted the birth of the Chinese securities markets and impacted the economic reform of the country on a national scale. Prior to 1979, the primary source of state revenue was government-collected taxes from state-owned enterprises. As a consequence of economic reform, the level of funds collected by the government from the state-owned enterprises dropped and the government issued bonds to make up the taxation shortfall.[21] The government was still unable to finance state-owned enterprises, and began requiring the companies to raise funds by issuing shares and debentures.[22] Furthermore, to meet the demand for capital expansion and market liquidity, securities markets were established in Shanghai in 1990 and Shenzhen in 1991.[23]

B. *The Development of Insider Trading Law in China*

Securities Trading in China has been supervised by a variety of regulatory authorities. Before October 1992, securities trading activities were mostly supervised by regulatory bodies at the provincial level. Between October 1992 and the end of 1998, securities trading activities were jointly supervised by local regulatory bodies and the China Securities Regulatory Commission ("CSRC"), an instrumentality of the central government.[24] Since August 1998, however, financial market activities have been regulated exclusively by CSRC.[25]

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21 I. A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 62 (1998).

22 *See* D. JIN, DANGDAI ZHONGGUO ZHENGQUAN SHICHANG [CONTEMPORARY SECURITIES MARKET OF CHINA] 21-23 (Shanghai 1999).

23 TOKLEY & RAVN, *supra* note 21, at 63.

24 CSRC is a branch of the State Council. Prior to August 1998, China's securities industry supervisory body was the Securities Commission under the State Council. CSRC was under the leadership of the Securities Commission. In August 1998, the State Council was restructured and CSRC became China's securities industry supervisory body.

25 CHINA SECURITIES REGULATION COMMISSION, SECURITIES PROFESSIONALS ADMISSION EXAMINATION COMMITTEE, ZHENGQUAN SHICHANG JICHU ZHISHI [BASIC KNOWLEDGE ABOUT SECURITIES MARKET] 320-21 (Shanghai 1999) [hereinafter BASIC KNOWLEDGE].

Before October 1992, local regulatory authorities promulgated various rules prohibiting abusive activities in China's financial markets. These rules contained provisions against insider trading, such as Articles 37, 39, 40 of *Measures for Regulating Securities Trading in Shanghai* (1990)[26] and Article 43(4) of *Tentative Measures for Regulating Securities Issuance and Trading in Shenzhen* (1991)[27] In 1993, the State Council's Securities Commission promulgated the Tentative Measures against Securities Fraud ("Tentative Measures")[28] The Tentative Measures contained more detailed provisions against insider trading activities than had previously existed in China.

The insider trading provisions in the Securities Law enacted in 1998 are almost identical to the provisions in the Tentative Measures. The only noteworthy difference, is that under the Securities Law, the State Council's securities regulatory bodies have the authority to determine which type of information amounts to inside information, aside from what is enumerated under Articles 62(2) and 69, and it grants exclusive regulatory authority given to the CSRC.

IV. THE INSIDER TRADING PROVISIONS OF THE SECURITIES LAW

A. Legislative Objectives of China's Insider Trading Law

The primary purpose of China's insider trading law is to protect investor's interests and ensure the stability of the financial market. Article 1 of the Securities Law states that the Law is formulated in order to standardize the issuing and trading of securities, to protect the lawful rights and interests of investors, to safeguard the social and economic order and the public interest, and to promote the development of the socialist market economy. According to the Finance and Economics Committee of the National People's Congress, the most "direct" purpose of the Securities Law is the protection of investors' interests. In a securities regulatory affairs meeting, Chen Yaoxian, Vice Chairman of CSRC, noted that the ultimate purposes of the securities regulation were to ensure the stability of the financial market, safeguard the market order and public interests, and protect

[26] Shanghaishi Zhengquan Jiaoyi Guanli Banfa [Measures for Regulating Securities Trading in Shanghai] (Nov. 27, 1990) (P.R.C.).

[27] Shenzhen Gupiao Shichang De Yunzuo Yu Guanli [Tentative Measures for Regulating Securities Issuance and Trading in Shenzhen] (May 15, 1991) (P.R.C.).

[28] Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa [Tentative Measures against Securities Fraud] (Aug. 15, 1993) (P.R.C.).

investors.[29] The efficacy of China's insider trading provisions hinges on whether it can facilitate the achievement of this purpose.

B. *Prohibited Acts Under China's Insider Trading Law*

Article 67 of the Securities Law prohibits informed persons with inside information about securities to use such inside information in carrying out securities trading. However, Article 68 and Article 69 curb the broad nature of this regulation. These provisions limit the scope of prohibited activities by providing a restrictive interpretation of the terms "informed persons" and "inside information."

1. *"Informed Persons"*

Under Article 68, only certain types of persons are considered "informed persons." They include:

(1) Senior officials of an issuing company;
(2) Shareholders who own 5% or more stock in the issuing company;
(3) Senior officials of the holding company of the issuing body;
(4) Persons who are able to obtain material company information concerning the trading of its securities by virtue of their positions in the company;
(5) Employees of the securities regulatory authorities and other persons with statutory duties pertaining to the regulation of securities trading;
(6) Employees of intermediary organizations that participate in securities trading pursuant to their statutory duties, employees of securities registration and/or clearance institutions, and securities trading service organizations; and
(7) Other persons specified by the State Council's securities regulatory authority.[30]

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[29] *See Chen Yaoxian Zai Quanguo Zhengquan Jianguan Gongzuo Huiyi Shang Yaoqiu Zhuanbian Guannian, Zhuanhuan Zhize, Ba Zhengquan Gongzuo De Zhongdian Zhuanyi Dao Jianguan Shanglai, [Chen Yaoxian Wants a Change of Ideology, a Change of Responsibilities and that the Focus of Securities (Regulatory) Work Be Shifted to (Securities) Supervision in the National Securities and Futures Regulation Meeting]* (Jan. 24, 1998), 1 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] 48 (1999) (P.R.C.).

This restrictive interpretation of "informed persons" severely limits the utility of the insider trading law. Article 68 allows insider trading activities to be carried out by many individuals who may have inside information. Moreover, the types of people listed under Article 68 may not always be in possession of inside information.

a. The types of insiders whom the Securities Law fails to catch

Article 68 fails to prohibit two types of people who possess inside information from engaging in insider trading: people who actually possess inside information but are not specifically listed under Article 68, and tipees of inside information.

1) Insiders who are not treated as "informed persons" under Article 68

The types of people who are deemed to be "informed persons" under Article 68 are individuals connected with the issuing company, employees of securities regulatory bodies, and employees of the securities service industry. However, people not included in Article 68 can often be privy to non-public material information. This class of persons can be illustrated by discussing two American cases. The first case is *Chiarella v United States.*[31] Chiarella was an employee of a financial printer that generated corporate documents. Chiarella traded on confidential, non-public information that he obtained by virtue of his status as an employee, making a profit of $30,000. The Second Circuit upheld Chiarella's conviction for breaching Section 10(b) of the Federal Securities Exchange Act and Securities and Exchange Commission ("SEC") Rule 10b-5.[32]

The Supreme Court of the United States, however, reversed the decision. The Supreme Court held that Chiarella was not a fiduciary of the issuing company and that trading on inside information by a person who is not a fiduciary of the issuing body does not amount to fraud under Section 10(b).[33] The theoretical basis the *Chiarella* court adopted is known as the "breach of fiduciary duty theory." One might pause here to observe that if the American insider trading law does not prohibit a person in Chiarella's

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[30] Securities Law, *supra* note 1, art. 68.
[31] United States v. Chiarella, 445 U.S. 222 (1980).
[32] *Id.* at 224-25.
[33] *Id.* at 234-35.

position from trading, why should China's law do this? The answer to this question is that the fiduciary duty theory has been superceded by the so-called "misappropriation theory," which was adopted in 1997 by the U.S. Supreme Court in *United States v. O'Hagan.*[34]

In *O'Hagan*, the defendant was a partner of a law firm that was retained in connection with a proposed corporate takeover. The defendant, who was not directly representing the firm's client, learned confidential details about the proposed deal from another partner. Based on this inside information, the defendant purchased 2,500 call options and 5,000 shares of common stock from the target company. When the tender was made public, the defendant sold his stock and call options, making a profit in excess of U.S. $4.3 million dollars. The Supreme Court held that a person violates Section 10(b) when the person (who deceptively misappropriates confidential information for securities trading purposes) is in breach of a fiduciary duty owed to the source of the information (as distinct from a fiduciary duty owed to the issuing company).[35] Presumably, had *Chiarella* been heard after *O'Hagan*, the Court would have applied the misappropriation theory in light of the facts of that case.

China's current insider trading law would not apply in either the *Chiarella* or *O'Hagan* scenarios. Neither Chiarella nor O'Hagan were officials or employees of the issuing company in question. Nor do they fall into any other category of "informed persons" defined under Article 68. Therefore, neither Articles 67 nor Article 68 could be employed in similar insider trading prosecutions in China.

2) Tipees

Tipees are not considered informed persons under China's Securities Law. Article 70 of the Securities Law prohibits an "informed person" or "other person who has illegally obtained inside information" from communicating inside information to others or procuring others to trade on such information. However, Article 70 does not prohibit a tipee from trading on the inside information himself. This is because a tipee is not treated as an informed insider under Article 68. Moreover, a tipee cannot be

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34 United States v. O'Hagan, 521 U.S. 642 (1997).

35 The Court stated, "We agree with the Government that misappropriation, as just defined, satisfies §10(b)'s requirement that chargeable conduct involves a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities." *Id.* at 653. Furthermore, the Court held, "The misappropriation theory comports with §10(b)'s language, which requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act . . . ." *Id.* at 658.

a "person who has illegally obtained insider information" under Article 70.[36] The failure to treat a tipee as an informed insider renders Articles 68 and 70 illusory since the types of persons listed under Article 68 can always communicate inside information to a relative or a friend. The relative or friend can then trade on the information for him or herself or even trade on behalf of the tipee.

b. Persons who are deemed to be insiders but do not actually possess inside information

Another problem is that the Securities Law considers many people to be "in possession" of inside information even when they do not actually possess such information. For example, it seems unfair to say that all employees of the securities regulating bodies possess inside information, nevertheless they appear to possess such information under Articles 62 and 69. In addition, senior officials of a company may not always be aware of every dealing that is considered inside information. For example, if the senior official is trading, but is unaware of a change in the amount of shares owned by a major shareholder or is unaware of a major mortgage, sale, or write-off, that official is in danger of being charged with insider trading violations.

Additionally, a shareholder who happens to hold five percent or more of the company's stock can inadvertently violate the Securities Law when the company does not have a duty to communicate every piece of inside information to him or her. Consider this scenario: Abel, a shareholder who held five percent of a company's stock was not aware of the company's default on a major purchase. Abel sells half of his shares for personal reasons before the company's poor quarterly earnings report are made public. At the discretion of CSRC, a Securities Law action can be brought against Abel. This is because he is considered an insider under Articles 68(2), and has traded on a type of 'inside information' listed under 62(4), which is prohibited by Articles 67 and 70. Additionally, the Securities Law does not provide Abel with any possible defenses to such a charge of insider trading.

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[36] Securities Law, *supra* note 1, art. 70.

2. *"Inside Information"*

Articles 62 and 69 of China's Securities Law determine what constitutes "inside information." Article 69 lists the "major events: that a company is required to disclose to the regulatory authority under Article 62, as well as a range of other types of information deemed to be "inside information." The following qualify as 'major events' under Article 62:

(1) A major change in the company's business policies or scope of business;
(2) A decision by the company concerning a major investment or major asset purchase;
(3) The company concludes a major contract potentially effecting the company's assets, liabilities, rights, interests or business results;
(4) The company incurs a major debt or defaults on a major debt;
(5) The company incurs a major deficit, or 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, or not less than one-third of the directors or managers of the company;
(8) A relatively major change in the ownership share of a shareholder who holds not less than five percent of the company's shares;
(9) A decision to reduce the company's capital, to merge, to divide or dissolve the company, or to file for bankruptcy;
(10) Major litigation involving the company where the court decides to lawfully revoke resolutions made at a shareholders' general meeting or by the board of directors; or
(11) Other events specified in laws or administrative regulations.[37]

The following information is regarded as "inside information" under Article. 69:

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[37] *Id.* art. 62.

(1) The major events described in the second paragraph of Article 62 of the Securities Law;
(2) Company plans concerning distribution of dividends or increases of registered capital;
(3) Major changes in the company's equity structure;
(4) Major changes in security for the company's debts;
(5) Any single mortgage, sale or write-off of not more than thirty percent of a major asset used in the business of the company;
(6) Potential liability for major damages to be assumed as a result of an act committed by a company's director(s), supervisor(s), manager(s), deputy manager(s) or other senior management personnel;
(7) Plans concerning the takeover of listed companies; and
(8) Other important information determined by the State Council's securities regulatory authority to have a significant or measurable effect on securities trading prices.[38]

Like the definition of "informed persons," the definition of "inside information" under Articles 62 and 69 renders the insider trading provisions largely ineffective. The reason for this is that the provisions fail to treat the most typical forms of inside information as inside information. Consider the following example:

> On April 1, the research scientists of X Drug Company inform the president of the company that they have discovered a cheap way of manufacturing "intervention," a substance thought to be effective in fighting cancer. The president realizes that if news of the discovery is released, the price of X stock will skyrocket from its current price of U.S. $30 per share. Instead of issuing a press release, the president keeps the good news under wraps while he buys as much X Stock as he can at the current market price. On April 15, he finally allows a press release to be issued. Upon the release, the market price of X stock immediately jumps to U.S. $100 and several days later the president sells his shares at the inflated price.[39]

[38] *Id.* art. 69.
[39] ROBERT CHARLES CLARK, CORPORATE LAW 264 (1986).

This "good news" situation, which is one of the most common insider trading scenarios, is not considered "inside information" under Articles 62 and 69. Therefore, the president in this example would not have engaged in insider trading activities under the Chinese Securities Law.

Front-running is another common form of insider trading that is not addressed in Articles 62 and 69. Front-running occurs when a broker/dealer, who knows a client has a large or market-sensitive order, engages in a transaction on his, her or another client's behalf, thereby benefiting from the pre-warning.[40] In other words, front-runners possess material information that a client has placed an order that will affect the market price of the shares to be transacted. This form of insider trading can occur when either shares or derivatives are traded,[41] as well as in the related instruments market.[42] Front-running is said to be an industry-wide problem and not specific to a region or a particular country.[43] Thus, there is reason to conjecture that front-running is among the most common and lucrative forms of insider trading engaged in by institutional investors.

Front-running is particularly relevant to large-scale fund managers, such as American owned Fidelity, which manage assets worth hundreds of billions of dollars.[44] Therefore, any large-scale securities purchase by such managers is likely to increase the price of the security, simply by virtue of the trading volume. Individual fund managers can make huge profits by trading ahead of the purchase. Some managers trade ahead for their own accounts as many as 500 times a year with an annual profit of U.S. $2.5 to 3 million.[45]

Scalping activities are another category of insider trading activity not considered to yield inside information under the Securities Law:

> Scalping is the practice of effecting a personal transaction of the fiduciary before effecting transactions in the same or related properties for the beneficiary, followed by further personal transactions to profit from the resultant market activity. One simple example is for the manager to acquire a sizeable position

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[40] Australian Stock Exchange Ltd., Circular to Member Organizations (June 21 1990).

[41] NICK BATTELY, AN INTRODUCTION TO COMMODITY FUTURES AND OPTIONS 100-01 (2d ed. 1995).

[42] Australian Stock Exchange Ltd., *supra* note 40.

[43] B. Carvalho, *India: Frontrunning is No Fair Race*, BUS. WORLD, Sept. 6, 1998, *available at* REUTERS BUSINESS BRIEF, http://www.briefing.reuters.com.

[44] Garth Alexander, *U.S.A.: Fidelity Denies Probe in Insider Trading*, SUNDAY TIMES (UK), Apr. 21, 1996, *available at* REUTERS BUSINESS BRIEFING, http://www.briefing.reuters.com.

[45] *Id.*

> of an obscure stock on the stock exchange, then direct the trustee to invest in such stock. The manager then sells in the market—presumably at a higher price as a result of the acquisition activities of the trustee.[46]

The material information the fund manager possesses in this scenario is that the price of the junk stock will be raised because of the trustee's purchase. While this activity has the same effect as other prohibited activities, it is not expressly forbidden by Articles 62 and 69.

3. *CSRC's Interpretive Power Does Not Solve the Security Law's Problems*

CSCR's interpretive power does not solve the Security Law's problems because the CSRC seldom uses this power to broaden the coverage of the insider trading laws. The narrow definitions of "insider" and "inside information" significantly curb the scope and potential effectiveness of the insider trading provisions of the Securities Law. However, the Securities Law contains additional provisions that could theoretically broaden the scope of the insider trading provisions. Articles 68(7) and 69(8) give discretionary power to the State Council's securities regulatory authority to identify "informed persons" and "inside information" not explicitly defined in Articles 68 and 69. Parliament intended these provisions to fill gaps not covered by the illustrative lists of Articles 68 and 69. If CSRC routinely exercised the interpretive power of Articles 68(7) and 69(8), these two sub-articles would remedy the deficiencies of the insider trading provisions. However, the CSRC seldom uses this power. A review of the insider trading cases reported in *CSRC Official Bulletin*[47] demonstrates that CSRC has rarely, if ever, exercised its interpretive power.

Additionally, CSRC decisions are difficult to effectively appeal because the appeals process does not flow through the proper legal channels. Under the Regulations of Administrative Reconsideration ("RAR"), an "administrative reconsideration" is normally conducted by the supervising body of the decision-maker.[48] When an aggrieved party is dissatisfied with the review of an administrative decision, he or she is able to have the administrative reconsideration reviewed by a court, assuming that such

[46] KAM FAN SIN, THE LEGAL NATURE OF UNIT TRUST 200 (1997).

[47] This includes cases reported in ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] up to March 2000.

[48] *See* Xingzheng Fuyi Tiaoli, [Regulations on Administration Reconsideration] (amended Oct. 9, 1994), arts. 11-22 (P.R.C.)

review is permitted by the law in question.[49] Article 210 of the Securities Law provides:

> If a person concerned is dissatisfied with a punishment decision of the securities regulatory authority, or the department authorized by the State Council, such person may apply for review or directly institute proceedings in a people's court according to law.

The securities regulatory authority in this context is the CSRC, which is a government instrumentality under the direct supervision of the State Council.[50] The appropriate review body of CSRC's decisions should therefore be the State Council's Legal Affairs Office. Thus, under Article 210, a person aggrieved by a CSRC decision has two avenues of appeal. First, the person can seek to have a CSRC decision reviewed by the State Council's Legal Affairs office. If the person is not satisfied with the outcome of the State Council's review, he or she may request a review by a court of law. Second, the person can seek to have CSRC's decision directly reviewed by a court of law.

The problem is that in practice, an appeal to the State Council's Legal Affairs Office is not available because the CSRC conducts administrative appeals of its own decisions. A CSRC punishment decision typically ends with a sentence stating that if the defaulting party is dissatisfied with CSRC's decision, the defaulting party should seek administrative reconsideration by CSRC within 15 days of the announcement of the decision, or initiate an administrative litigation proceeding in a court of law, with proper jurisdiction, within three months of the decision.[51]

In summary, the problems with the narrow scope of the insider trading laws are not solved by the interpretive powers granted to the CSRC. The CSRC seldom exercises its discretion to broaden the definitions of "insider" or "insider information." Moreover, CSRC decisions are difficult to effectively appeal because the appeals process does not flow through the proper legal channels.

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49 A person aggrieved by various types of administrative decision is able to seek judicial review of the administrative decision in question. Decisions of a body that conducts administrative considerations are also subject to judicial review. Zhonghua Renmin Gongheguo Xingzheng Susongfa [The People's Republic of China Administrative Litigation Law] (enacted Apr. 4, 1989), arts. 11, 25 (P.R.C.).

50 BASIC KNOWLEDGE, *supra* note 25, at 320-22.

51 *See, e.g.*, CSRC's decision on the punishment of Fujian Xingye Securities Co. for breaching securities law and regulations (Mar. 31, 2000), 23 ZHENGJIAN CHA ZI [CSRC OFFICIAL BULL.] (2000), *at* http://www.csrc.gov.cn/ (last visited Sept. 14, 2000).

C. *Liabilities for Engaging in Insider Trading Activities*

The liability scheme of the Securities Law is contained in Article 183. Under this Article, a person who breaches insider trading provisions must dispose of the illegally obtained securities.[52] The profit made by virtue of the breach must be confiscated. In addition, the person is fined an amount that is (1) greater than or equal to the amount of the illegally obtained income, but less than five times the amount of the illegal income, or (2) less than the value of the securities illegally purchased or sold. If the matter constitutes a criminal offense, criminal liability must be pursued according to law.[53]

Article 183 does not achieve the legislative purpose of the Securities Law because it does not instill a sense of investor protection, it does not afford alleged offenders fair treatment, and it is difficult to implement.

1. *The Efficacy of Article 183*

In Chinese law, conduct that is in breach of a legislative provision is considered a crime only if it violates the Criminal Code.[54] As discussed above, insider trading is penalized by imposing fines and confiscating profits made through insider trading activities. The State Council's securities regulatory authority, instead of the courts, deals with all breaches of the Securities Law under Article 167(7). Therefore, insider trading liability under the Securities Law is an "administrative penalty" and is not a criminal offense.[55]

An administrative penalty regime, however, does not help achieve the legislative purpose of the insider trading provisions. An administrative penalty regime largely immunizes inside traders from criminal prosecution and civil liability. The provision stating that a suspect can be criminally liable if the insider trading conduct constitutes a crime has limited practical value. Neither the Securities Law nor the Criminal Code define the type of prohibited conduct that constitutes a criminal offense. To clarify such an undefined concept in a statute, it is important to refer to the judicial interpretations issued by the Supreme People's Court or the Supreme

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52 Securities Law, *supra* note 1, art. 183.

53 *Id.*

54 WU, Z., FAXÜE GAILUN [AN INTRODUCTION TO LAW] 171-72 (Beijing 1994).

55 An administrative penalty is imposed by the State on a person who has breached a law other than the Criminal Law. Such a penalty is imposed by an administrative body rather than a court. XINGZHENG FA [ADMINISTRATIVE LAW] 205-07 (L. Wang & S. Zhang eds., Beijing 1993).

People's Procuratorate.[56] However, there have been no judicial interpretations issued as to what type of trading conduct constitutes a crime. Further, there have never been any criminal prosecutions for engaging in insider trading or market manipulation activities in China.[57] Such a failure to criminalize insider trading seriously limits the deterrent effect of the insider trading provision under the Securities Law.

Additionally, investors' interests are not protected by civil law. Article 183 fails to make those who violate the Securities Law liable to victim-investors for monetary compensation. A person whose interests are injured by insider trading activities is thus left without a remedy under the Securities Law. Moreover, it is unlikely that a victim of insider trading will be compensated under tort law. Deceit is not a cause of action under Chinese tort law. The only possible source of a remedy in tort appears in Article 117 of the General Principles of the Civil Law of the People's Republic of China. Article 117 states that "[a]nyone who encroaches on the property of the state, a collective or another person shall return the property; failing that, he shall reimburse its estimated price." However, it would be difficult, if not impossible, to prove that an insider trader encroached on the property of a victim investor, given the impersonal nature of the securities market.

An administrative penalty imposed under Article 183 benefits only the government. All income from the fines and confiscation go directly to the Chinese Government instead of the victim-investors. Moreover, all victim-investors are left without compensation for their damages under the current administrative penalty regime.

2. *The Treatment of Alleged Offenders.*

The treatment of alleged offenders under Article 183 is likely unconstitutional and violates the Universal Declaration of Human Rights ("UDHR") and the International Covenant on Civil and Political Rights ("ICCPR").[58] The administrative penalty prescribed under Article 183 not

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[56] D. Zhou, *A Review of New China's Judicial Interpretation and Reflections on the Perfection of Judicial Interpretation*, *in* A COMPLETE COLLECTION OF THE JUDICIAL INTERPRETATIONS BY THE SUPREME PEOPLE'S COURT OF THE PEOPLE'S REPUBLIC OF CHINA 1, 8 (Beijing 1994).

[57] Telephone Interview with Song Yongxin, Associate Professor, Zhejiang University Faculty of Law (Aug. 2, 2000); Telephone Interview with Dr Lu Yiping, Senior Judge, Shen Zhen Intermediate People's Court (Sept. 5, 2000).

[58] Universal Declaration of Human Rights 1948, U.N. GAOR, 3d Sess. at 71, U.N. Doc. A/810 (1948) (adopted Dec. 10, 1948) [hereinafter UDHR], *available at* http://www.un.org/Overview/rights.html.; International Covenant on Civil and Political Rights, art. 12(4), 21 U.N. GAOR

only fails to protect investors but also fails to treat the alleged insider trading offenders fairly. An administrative penalty can be in the form of, *inter alia*, a fine, or detention.[59] Therefore, it may involve an invasion of a person's basic rights guaranteed under the Constitution of the People's Republic of China. These Constitutional rights include those given by Article 13, concerning property rights, and Article 37, guaranteeing the right to liberty.[60]

The imposition of these penalties without a public trial amounts to a breach of Article 11 of the UDHR, which provides that "(e)veryone charged with a penal offence has the right to be presumed innocent until proved guilty according to law in a *public trial* at which he has had all the guarantees necessary for his defense."[61] Thus, under Article 11, a person suspected violating the Securities Law is entitled to a public trial and should be presumed innocent.

The monetary penalties imposed under Article 183 most likely violate equal protection. Article 7 of the UDHR and Article 26 of the ICCPR, guarantee that equal protection be accorded to all people. The monetary penalty imposed under Article 183 is identical to that imposed under Article 180 of the Criminal Code.[62] However, the procedures for determining whether there is civil liability or criminal liability are different. To establish civil liability in common law jurisdictions, the court need only be satisfied on the balance of probabilities; whereas the standard of proof for criminal

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Supp. (No. 16) at 52, U.N. Doc. A/6316 (1966) (entered into force Mar. 23, 1976). China has signed both, but has not ratified either document.

59 Thus, administrative penalties are considered penal offenses. In China, a penal offense does not have to be a criminal offence, since only breaches of China's Criminal Code with serious consequences are treated as crimes. This scheme is not unique to China. Certain provisions in Australia's Corporation's Law also have "Civil Penalty Provisions." A prima facie breach of such a provision may not constitute a criminal offence, but will attract penal consequence in the form of a fine.

60 The Constitution provides that the state protects private individuals' ownership of lawful property. PRC CONST., *supra* note 19, art. 13. Article 37 of the Constitution provides: "Freedom of the person of citizens of the People's Republic of China is inviolable. No citizens may be arrested except with the approval or by decision of a people's procuratorate or by decision of a people's court, and arrests must be made by a public security organ. Unlawful detention or deprivation or restriction of citizens' freedom of the person by other means is prohibited, and unlawful search of the person of citizens is prohibited." PRC CONST., *supra* note 19, art. 37.

61 UDHR, *supra* note 58, art. 11 (emphasis added).

62 However, insider trading is also punishable by imprisonment. Zhonghua Renmin Gongheguo Xingfa [Criminal Law of the People's Republic of China] (adopted by the Second Session of the Fifth National People's Congress, July 1, 1979, amended by the Fifth Session of the Eighth National People's Congress, Mar. 14, 1997) art. 180 (P.R.C.), *translated in* http://www.qis.net/chinalaw/ prclaw60.htm. In China, a prima facie breach of the Criminal Law is not regarded as a crime unless the breach causes serious consequences. *Id.* art. 13. For this reason, the Securities Law provides that if the matter constitutes a criminal offence, criminal liability shall be pursued according to law. Securities Law, *supra* note 1, art. 183.

liability is beyond reasonable doubt. It is contrary to Article 7 of the UDHR and Article 26 of the ICCPR to provide different standards of proof.[63]

While domestic Chinese laws that contravene international human rights law have not yet caused any practical problems for China's legislators and courts, this situation is likely to change. China's entry into the WTO opens the country's financial market to overseas investors. Subjecting overseas investors to a law that violates international human rights laws may lead to legal challenges and a loss of foreign investment.

3. *The Practical Problems with Implementing Article 183.*

The problems with implementing Article 183 relate to the following requirement: "(i)n addition, a fine of not less than the amount of, and not more than five times the illegal income, or a fine of not more than the value of the securities illegally purchased or sold, shall be imposed."[64] Essentially, to make an order pursuant to this Article, CSRC will need to make a choice between:

(1) A fine of not less than the amount of, and not more than five times, the illegal income; and
(2) A fine of not more than the value of the securities purchased or sold.

In practice, choice one mainly applies to traders of good news because traders on bad news do not typically make a profit. Most insiders who trade on bad news do so to avoid loss.[65] Choice two penalizes both traders of good news and traders of bad news. Therefore, traders of good news can be penalized under either option. Article 183 does not give any guidance as to which choice applies in a situation where an insider trades on good news. Furthermore, it does not clarify whether the basis for calculating the monetary penalty should be determined by the value of shares before or after the trading.

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[63] This situation may soon change because an evidence law is currently being drafted. Interview with Professor Chen Guiming, Professor of Law, China University of Political Science and Law, in Gold Coast, Australia (Aug. 24, 2000); Dr. Lu Yiping, *supra* note 57.

[64] Securities Law, *supra* note 1, art. 183.

[65] However, profits can be made by trading short on bad news. For example, an insider who trades short would borrow a large number of shares from somebody else, sell them prior to the release of the bad news, purchase them back when the price drops from the bad news, and return the lender's shares. The profit made by the insider in such a situation is the difference between the share price prior to and subsequent to the release of the bad news.

This lack of guidance will certainly cause problems, as the following example illustrates. Ian purchases 10,000 shares with $10,000 before the release of a piece of good news. Ian sells the shares after the announcement of the news at a price of $1.50 per share, realizing a $5,000 profit. If the "value of securities" refers to the value of the securities before the trading, then under choice two, Ian can be fined up to $10,000. If, however, the value of securities after the transaction is adopted as a basis of calculation, Ian will be liable for a fine of up to $15,000. Further, under choice one, the size of the fine could be as high as $25,000. Because of the large disparity in fines that can be imposed under choices one and two, the feasibility of imposing Article 183 penalties is in serious question. This lack of uniformity, together with the narrow interpretation of who is covered by the insider trading provisions reduces their efficacy.

V. REFORM PROPOSAL

A. *China's Definition of "Insider" Should Be Repealed in Favor of Australia's "Access to Information" Definition*

China's closed-ended definition of "informed person" is inappropriate because the targeted "insiders" may not possess inside information and persons falling outside of the definition may actually have inside information. To remedy this situation, China should adopt Australia's "access of information" approach, embodied in section 1002G of Australia's Corporations Law.[66]

Under section 1002G, a person is prohibited from trading on information when the person possesses information that is not generally available, and, if the information were generally available, a reasonable person would know, or should know that the information would have a material effect on the value of a company's stock. Under this approach, individuals who are not explicitly mentioned in Article 68 of the Securities Law but who are in possession of inside information, such as the perpetrators in *Chiarella* and *O'Hagan*, as well as their tipees, would be in breach of the insider trading law. Additionally, people deemed insiders but who do not possess any inside information would not be subject to legal actions.

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[66] Corporations Law, § 1002G (Austl.), *in* AUSTRALIAN CORPORATIONS LEGISLATION 1059 (Butterworths 2000).

B. *The Securities Law's "Inside Information" Definition Should Be Based on the "Materiality" of the Information Possessed*

The closed-ended definition of "inside information" contained in Article 69 cannot cover all conceivable types of inside information. On this point, Australia's flexible approach to the definition of "inside information" is more commendable. Section 1002G of Australia's Corporations Law prohibits an insider from trading on "material" non-public information. Section 1002C explains "material effect" as a situation in which:

> [a] person would be taken to expect information to have a material effect on the price or value of securities of a body corporate if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell the first-mentioned securities.[67]

This broader definition of materiality is capable of capturing additional forms of insider trading, since material non-public information capable of affecting the price of the security in question is the only standard. Insiders do not gain any advantage by trading on non-public information that does not affect the change of price of the security.

It is advisable for China's legislators to consider adopting the Australian approach, by enacting provisions that prohibit a person who is in possession of non-public material information from trading. Defining inside information as non-public material information will prohibit a wider range of insider trading. It will remedy the current situation by prohibiting people who are in possession of non-public material information, but are not listed in Articles 62 and 69, such as front-runners, people who are involved in scalping practices, and tipees from trading on the information they possess.

C. *China Should Abandon Administrative Enforcement of the Securities Law*

Ideally, China should abandon the notion and practice of the administrative penalty in its insider trading laws. The rationale behind the existence of the administrative penalty regime is likely that it is more expedient to govern without going through due process for every penalty

67 *Id.* § 1002C.

imposed by the state.[68] This view is based on the assumption that an administrative penalty regime is less costly then a legal penalty regime. However, this may not be the case, as judicial officers in China are not necessarily better remunerated than administrators.[69] Instead, China would likely spend roughly the same amount of money accomplishing the same task without violating due process. Moreover, the administrative and criminal penalty divide will likely not survive China's entry to the WTO. Therefore, China should abandon the practice of utilizing administrative penalties for insider trading violations.

In the alternative, the courts should be given the power to determine who are insiders and what constitutes inside information, and the appropriate appellate review of CRSC decisions should be enforced. Article 210 should explicitly state that the CRSC may not review its own decisions. This would provide meaningful review of CRSC decisions and thereby increase the likelihood that the Securities Law will be fairly enforced.

D. Liabilities for Insider Trading Should Be Supplemented and Clarified

1. Additional Civil Remedies

To achieve the legislative purpose of the Securities Law, Article 183 should provide civil remedies for insider trading. For example, the Law could give the CSRC and Chinese courts the power to order the perpetrator to compensate innocent parties to the extent of their losses suffered.

CSRC should also be given the power to bring civil actions in the name of, and for the benefit of, companies. This power is necessary in situations where the company in question is unable to bring the action because of financial restraints or where the company is reluctant to take legal action against its own officers. CSRC should also be given a similar power to bring a civil action on behalf of an individual whose interests are hurt by the insider trading activities. This power is necessary for the public interest in situations where the injured party lacks the financial means or motivation to take legal action against the suspected insiders.

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[68] Dr. Lu Yiping observed that the rationale for the existence of the administrative penalty regime was that it consumes too much time and resources if every unlawful act (as distinct from every criminal conduct) needed to be dealt with by the judiciary. Dr. Lu Yiping, *supra* note 57.

[69] Telephone Interview with Mr. Wu Jun, Managing Partner of Grand & Associates, Beijing (Oct. 8, 2000).

2. *Clarification of Problems Associated with Implementing Article 183*

There are two options regarding the imposition of the existing non-civil penalties under Article 183. Clear guidance should be given as to the amount of penalty that is to be imposed. A guiding principle may read, "whichever is greater in value." Where a fine is provided, and the value of the fine is to be determined by reference to the value of the securities traded, the provision should state whether the value of the securities *before* or *after* the trading is to be used as the basis for calculating the amount of penalty.

VI. CONCLUSIONS

A prohibition against insider trading is necessary in China for at least two practical reasons. First, China is about to open its financial markets to foreign investment. It will need to make investors feel confident about the integrity of its financial markets to attract needed investment from overseas. Second, insider trading can harm investors' interests and even the national economy when it is associated with other forms of abusive trading activities, such as market manipulation and short-selling. China should therefore construct an insider trading regime for the purpose of protecting the interests of market investors. Regrettably, the insider trading provisions under China's first uniform Securities Law are incapable of achieving this purpose. Given the narrow definitions of "informed person" and "inside information," the provisions are incapable of identifying and preventing many instances of insider trading. Even if insider trading activity is identified, perpetrators do not face criminal prosecution or civil liability under the current insider trading law. Insider traders are only liable for paying administrative penalties, the sole beneficiary of which is the Chinese government.

The reform proposals in Part IV are based on Australia's insider trading law. The Australian approach supports a broader range of prohibition than the American approach because the Australian approach does not require the perpetrator to be a fiduciary to the source of information in order to be liable for insider trading. This is a desirable approach because trading on non-public material information by a non-fiduciary can be just as harmful.[70] The fiduciary duty and misappropriation theories that have been developed by the American courts in their interpretation of §10(b) of the

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[70] U.S. v. Cherif, 943 F.2d 692 (7th Cir. 1991). In *Cherif*, the defendant convinced his girlfriend, a bank employee, to write a fictitious memo enabling him access to the bank's financial department. The defendant was not a fiduciary of the bank of the issuing companies. *Id.* However, the effect of his trading would not have been different had he been a fiduciary.

Securities Exchange Act of 1934 require the presence of a "deceptive device or contrivance." However, in China, as in Australia, courts are not limited by this constraint. Therefore, it is not necessary for China to adopt the American fiduciary theories. The Australian approach is not based on common law fiduciary principles and will therefore be easier for China to adopt and to enforce.