
The Regulation of Insider Trading in China: Law and Enforcement

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Outline

1. Background
2. What constitutes insider trading in China?
3. How is the law enforced?
4. Conclusion

1. Background

- The regulatory framework
 - Regulator
 - China Securities Regulatory Commission (CSRC)
 - law
 - Securities Law
 - CSRC rules
 - Judicial interpretation

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- The extent of insider trading
 - My 2003 empirical finding: widespread
 - Now:
 - GEM market in 2009
 - Margin lending & short sale in 2010
 - on 16 November 2010, a joint circular by CSRC et al. on the need to strengthen the efforts to crack down on insider trading in China

2. What constitutes insider trading in China?

- Insiders: s 73 of Securities Law 2005
 - Persons with knowledge of inside information on securities trading (内幕信息知情人) or persons illegally obtaining inside information (非法获取内幕信息人) are prohibited from using such inside information to engage in securities trading activities
 - Comments: Two categories of insiders
 - US influence:
 - Equality of access theory; classical theory; misappropriation theory
 - Cf Australian law: equality of access theory; “information-connection only” approach

S74: who are ‘persons with knowledge of inside info’?

- Traditional insiders (corporate insiders)
 - (1) Directors, supervisors, and senior managers of an issuer;
 - (2) Shareholders who hold no less than 5% of the shares as well as their directors, supervisors, and senior managers, or the actual controller of a company as well as the directors, supervisors, and senior managers thereof;
 - (3) The company controlled by an issuer as well as its directors, supervisors, and senior managers thereof;
 - (4) persons with access to relevant inside information of a company by reason of their posts in the company;

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- Constructive insiders (temporary insiders)
 - (5) The functionary of the securities regulatory body, and other personnel who administer the issuance and transaction of securities pursuant to their statutory functions and duties;
 - (6) The relevant personnel of sponsors, underwriters, stock exchanges, securities registration and clearing institutions and securities trading service organizations; and
 - Securities firms; lawyers; accountants etc
 - (7) Any other person as prescribed by the CSRC
 - Who are they?

- persons illegally obtaining inside information (非法获取内幕信息人)
 - [Judicial Interpretation on Several Issues concerning the Application of Insider Trading Law in Criminal Cases]
 - (promulgated by the Supreme People's Court and the Supreme People's Procuratorate on 29 March 2012, effective from 1 June 2012)
 - Article 2:
 - (1) the inside information is obtained through such ways as theft, cheating, tapping, spy, extraction, bribery and private trading;
 - (2) the close relatives of primary insiders, or people with other types of close relationships with primary insiders;
 - (3) people who have contact with primary insiders during the sensitive period of the inside information.

What is inside information?

- s 75: Scope of inside info
 - S75(1): General standard
 - The term “inside information” refers to the information that concerns the business or finance of a company or may have a major effect on the market price of the securities thereof and that hasn't been publicly disclosed in securities trading.

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- Two features of insider information
 - Non-public
 - Price-sensitive (materiality)
 - Hard to quantify what constitutes ‘major effect’
 - “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”: *TSC Industries Inc v Northway Inc* 426 US 438

Regime (cont)

- S75(2): A list of inside information
 - The major events as prescribed in Article 62(2) of the Securities Law;
 - Relationship between inside information and continuous disclosure
 - And also...
 - The plan of a company concerning any distribution of dividends;
 - Any major change in the company's equity structure;
 - Where the mortgaged, sold or discarded value of a major asset as involved in the business operation of the company exceeds 30% of the said asset in a one-off manner;
 - The relevant plan of a listed company regarding acquisition; and
 - ...
 - Any other matter as prescribed by CSRC

S67(2): what are “major events”?

- S67(2): Checklist of ‘major events’ for continuous disclosure
 - A major change in the business guidelines or business scope of the com
 - A decision of the com on any major investment
 - An important contract as concluded by the com
 - Any incurrence of a major debt or default on an overdue major debt
 - A change concerning directors, no less than one-third of supervisors or managers of the com
 - A considerable change in the holding of SH or actual controllers
 - A decision of the com on capital decrease, merger, division, dissolution, or application for bankruptcy
 - ...
 - Any other matter as prescribed by CSRC

prohibited activities

- Article 76:
 - Any person who has the knowledge of inside information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information, or advise any other person to purchase or sell such securities.
 - Three forms of activity are prohibited
 - Trading;
 - tipping;
 - procuring

What constitute tipping?

- Former CSRC staff Li Li (李莉) case
 - Facts:
 - CSRC staff (first at Inspection Bureau, then Administrative Penalty Committee)
 - In 2008, her ex-husband and ex-mother-in-law blew the whistle, reporting to the CSRC that Li sent mobile message containing inside information to her mother
 - CSRC investigated and claimed that there was no insider trading issue as Li's mother did not trade
 - Comments:
 - Insider tipping?
 - Who should investigate?

Subjective elements

■ Three issues

- 1. Possession of inside info
- 2. Knowledge that the info is inside info
- Comments: evidentiary problems
 - Direct evidence/Circumstantial evidence
 - Insider registration system: CSRC
 - Reversing the burden of proof for people such as directors and senior managers
 - 2012 Judicial Interpretation on Insider Trading Law in Criminal Cases: art 1
 - the presumption can be rebutted

- 3. “possession v use” debate

- Q:

- Is mere *possession* of inside info sufficient or is there a further requirement that the defendant actually *used* the info?

- What is China’s position?

- Article 73 suggests ‘use’

- But Article 76 is not clear

Cases

- Deng Jun & Qu Li (邓军、曲丽) Insider Trading Case (2008)
 - Defence: independent research and judgement/coincidence
- Pan Haishen (潘海深) Insider Trading Case (2008)
 - Defence: operation mistake
- Comments:
 - 'Strong Reference rule': possession means use unless proven otherwise
 - Needs more clarity on acceptable defences

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- 2012 Judicial Interpretation on Insider Trading Law in Criminal Cases: art.4
 - a transaction conducted by a person in possession of inside information would not be treated as inside trading if the transaction is conducted
 - according to pre-existing written contract, plan or instruction, or
 - based on other legal source of information or other legal grounds

3. How is the law enforced?

- Enforcement

- Public enforcement

- CSRC

- Administrative liability; criminal liability

- private enforcement

- Allowed in principle, but no detailed rules

Empirical data: cases from 1991-2011

■ Methodology

- From 1991 till the end of May 2011
- Sources:
 - official website of the CSRC.
 - electronic database of Chinese law
 - media reports
 - Others

Empirical findings

- a total of 39 cases

Table 1: CSRC Cases on Insider Trading, 1991-2011

Time range	Number of cases	Percentage
1991-1995	2	5
1996-2000	7	18
2001-2005	3	8
2006-2010	25	64
2011-	2	5
Total	39	100

Table 2: Who was the insider?

Types of insiders	Number of cases	Percentage
Traditional insiders	36	70
Constructive insiders	5	10
Government officials	3	6
Listed companies themselves	3	6
Others	4	8
Total	51	100

Table 3: What was the inside information about?

Content of inside information	Number of cases	Percentage
Mergers and acquisitions	22	57
Major contracts or investments	6	15
Earnings	5	13
Dividend distribution plan	2	5
Capital increase	2	5
Others	2	5
Total	39	100

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- How has criminal liability been used?
 - although criminal liability for insider trading has been available since 1997, it was not employed until 2003 in the *Shenshen Fang case*.
 - Out of 39 insider trading cases examined in this study, criminal prosecutions are brought in up to 10 cases, or about 26% of all cases.
 - aggressive use of criminal sanctions in recent years, particularly after 2008 (8 out of 10 criminal cases)

Analysis of empirical findings

- General comments

- in recent years, there has been a significant increase in the number of insider trading cases, with a growing tendency to use criminal sanctions.
- This comes as China has vowed to strengthen its enforcement efforts, and launched a nationwide high-profile crackdown against insider trading.

- International comparison

- Next slide

■ UK

- During the period from 2001 and 2007, the Financial Regulatory Authority (FSA) in the UK reportedly brought only eight insider trading cases.
- it was not until 2009 did the UK have its first insider trading criminal prosecution, namely *R v McQuoid* [2009] EWCA Crim 1301 (CA).

■ US

- between 2001 and the fall of 2006, there were over 300 insider trading enforcement actions brought by the Securities and Exchange Commission (SEC) against over 600 individuals and entities.

■ Australia

■ HK

Public enforcement

- How to assess enforcement intensity?
 - enforcement outputs,
 - enforcement actions brought and penalties imposed
 - enforcement inputs,
 - the budget and staff size of the regulator
 - E.g.,
 - John C. Coffee, Jr., '*Law and the Market: The Impact of Enforcement*' (2007) 156 *U. Pa. L. Rev.* 229
 - Howell E. Jackson & Mark J. Roe, '*Public and Private Enforcement of Securities Laws: Resources-Based Evidence*' (2009) 93 *Journal of Financial Economics* 207

■ China

- Are the regulatory resources actually used in a fair, transparent and efficient way?
- one more important dimension to the question
 - the political economy of regulation and institutional integrity of the regulator

Huang Guangyu case

- Mr. Huang was once the richest self-made man in China (founder of Gome)
- during the period from April to September 2007, Mr Huang bought RMB 1 billion yuan worth of shares in a company called Beijing Zhongguancun, making use of the inside information on the corporate restructuring of the said company
- In 2010, Mr Huang was sentenced to nine years in prison and fined RMB 0.6 billion yuan (roughly USD 93 million)
 - both the imprisonment term and the amount of monetary penalty are the highest so far in China's insider trading enforcement history



More story...

- In April 2009 when he was detained for market misconduct, he just turned 40 and attempted suicide in the detention centre.
 - This was quite surprising, as Mr. Huang reportedly had a very strong mind and experienced many ups and downs in his life.
 - Many believed that his suicidal attempt was not due to the problem of market misconduct, but political pressure.
- Soon after Mr. Huang's detention, a number of high-ranking officials were detained and penalized...
 - Mr Zheng Shao Dong, the assistant to the Minister of Public Security of the PRC;
 - Mr Chen Shaoji, a minister-ranking official in Guangdong
 - ...
- It was suspected that, this background had something to do with the severe penalty Mr. Huang finally received for the commercial crimes.

Private enforcement

- The Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from False Statement on the Securities Market (15 January 2002)
 - securities civil cases can be brought against misrepresentation only, to the exclusion of other types of securities fraud such as insider trading

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- On 30 May 2007, however, Mr Xi Xiaoming, the vice-president of the SPC, stated
 - at a national conference on the adjudication of civil and commercial cases,
 - that courts should also accept securities civil cases arising from insider trading and market manipulation.

■ Comments

- Since the conference, there have been some attempts to bring civil cases for insider trading
 - All failed or still pending
- Problems
 - The bringing of civil cases against insider trading has a shaky legal basis: just conference speech!
 - the conference speech just calls for the courts to accept securities civil cases arising from insider trading, without providing detailed guidance on how such cases should be adjudicate

4. Conclusion

- Good progress has been made
- Long and winding road ahead...