Regulation with Random Standards: Administrative Enforcement of Tipper Liability in China's Insider Trading Cases

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Introduction

As a result of concentrated ownership structures and weak outside supervision, insider trading has long been a problematic issue in China's capital markets. Mallin concluded that

> "some Chinese state owned subsidiaries, including those operating outside China, may have a poor level of corporate governance. CEOs may be all-powerful and able to take decisions that are not in the best interests of the company and its shareholders. Limited disclosure may exacerbate the situation".[1]

Many scholars have expended substantial efforts in exploring this topic in the Chinese context, and there are certain subjects upon which agreement has been achieved among these scholars. For example, there is little doubt that although the insider trading rules of Chinese securities law are (in large part) transplanted from the US, they remain incomplete and inconsistently organised.[2] Furthermore, solid empirical evidence suggests that enforcement of insider trading activities by the China Securities Regulatory Commission (CSRC) remains weak and insufficient.[3] Beyond these general matters, however, the important issue of tipper liability remains under-researched in China's securities laws. By examining the enforcement of tipper liability in China, at least two types of information can be revealed. First, from a purely legal perspective, it remains unclear whether recklessness constitutes sufficient grounds for the CSRC to punish corporate insiders who leak inside information to tippees without an interest exchange, or whether the CSRC can punish only de facto conspiracies in which the tipper deliberately provides material information to benefit a tippee. It is important that these matters be clarified. In modern business society, corporate executives rarely engage in insider trading alone. Instead, they tend to employ "white gloves" to conduct these activities and thus to circumvent legal liability. Furthermore, such executives may use inside information as an important chip with which to exchange benefits with other parties. Secondly, and more importantly, beyond these sophisticated technical issues, research on the enforcement of tippers' liability may also have important implications for China's regulatory and legal institutions. In particular, such research leads naturally to the following broad questions. Is judicial review meant to act as a check on the CSRC's power in a broader balance of powers scheme? Is the regulator equipped with sufficient resources to address the wide range of insider trading activities in China? Finally, is the regulator captured by powerful insiders or otherwise corrupt?

General background

Administrative regulation undoubtedly plays the most important role in China's regulatory regime. As one Western scholar has argued,

> "rather than existing to provide clear notice to private parties of legal rights and duties, PRC [People's Republic of China] legal enactments exist to facilitate management of a complex society by an administrative state".[4]

Notably, no formal legislation was enacted to govern state-owned enterprises (SOEs) in China until 1988. The typical functions of formal corporate legislation—such as protecting creditors and holding managers accountable—were simply performed by state administrative procedures.[5] This culture of strong administrative regulation has been passed on to the current regulatory regime. The CSRC is the public regulator of China's equity markets. In contrast to some regulators in developed nations, the CSRC is not a quasi-governmental organisation. Instead, it is an administrative organisation controlled by the central government.[6] In accordance with China's Securities Law of 2005, the CSRC's powers are divided into three parts: (1) regulation; (2) investigation

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1 C. Mallin, *Corporate Governance*, 2nd edn (Oxford: Oxford University Press, 2006), p.6.

2 N. Howson, "Enforcement without Foundation? Insider Trading and China's Administrative Law Crisis" (2012) 60 *American Journal of Comparative Law* 955; and H. Huang, "Insider Trading and the Regulation on China's Securities Market: Where Are We Now and Where Do We Go From Here?" (2012) 5 *Journal of Business Law* 379.

3 B. Liebman and C. Milhaupt, "Reputational Sanction in China's Security Market" (2008) 108 *Columbia Law Review* 929.

4 W. Hutchens, "Private Security Litigation in China: Material Disclosure about China's Legal System" (2003) 24 *University of Pennsylvania Journal of International Economic Law* 599, 625.

5 D. Clarke, "Corporate Governance in China: An Overview" (2003) 14 *China Economic Review* 496.

6 The CSRC defines itself as a "ministerial-level public institution directly under the State Council"; see Introduction on the CSRC's official website available at: *http://www.csrc.gov.cn/pub/csrc_en/about/intro/200811/t20081130_67718.html* [Accessed 5 August 2016].

and supervision; and (3) legal enforcement. Its powers are both proactive and reactive, and it plays an important role in promoting compliance with and enforcing market regulations.[7] First, by enacting quasi-legislation (regulations and guidelines) to implement the principles of the Company Law of 2005 and the Securities Law, the CSRC contributes considerably to increasing legal certainty regarding corporate governance issues.[8] In general, these regulations and guidelines are legally binding, and all listed companies must comply with them.[9] Secondly, the CSRC actively exercises supervisory and legal enforcement powers. In terms of proactive enforcement, it is responsible for verifying the articles of association of companies listed in the PRC and to ensure that all the companies in China's securities market meet the required corporate governance standards.

Arguably, the US has developed an intensive regime for regulating insider trading. In the *Texas Gulf Sulphur* case, the US Second Circuit Court of Appeals held that "all investors trading on impersonal exchanges" should have "relatively equal access to material information" and "be subject to identical market risks".[10] This is the so-called "equal access of information" doctrine, which was subsequently abolished by later case law. In *Chiarella v United States*,[11] the US Supreme Court rejected the "equal access policy" in favour of the "fiduciary duties theory". Indeed, the Court clearly enunciated that liability could be imposed only if a defendant were subject to a duty to disclose prior to trading. Thus, insider trading liability was defined more narrowly. Under the updated doctrine, market analysts are not prohibited from trading equities in accordance with inside information, as they are not subject to a fiduciary relationship with any of the listed companies that they follow. Arguably, the fiduciary relationship doctrine facilitates market analysts' active role in the capital markets. The most recent development in the insider trading doctrine is that inside information is considered an important asset of a company that can be used only in the interests of the company. According to such an understanding, insider trading can be regarded as misappropriation of a company's property. In *US v O'Hagan*, the Court confirmed that an insider is prohibited from using "confidential information for securities trading purposes, in breach of a duty owed to the source of the information", even if the inside trader had no duties to the persons with whom he traded or the issuer of the securities that he traded. This case established the "misrepresentation theory".[12]

It seems that the Chinese Securities Law has adopted a "quasi-misrepresentation approach" towards insider trading activities. Article 74 defines a person who is considered an "insider" in general. According to the law, the following types of persons will be prohibited from trading listed companies' stocks when they have undisclosed material information:

1) corporate directors, supervisors, other executives, and major shareholders who hold no less than 5% of the shares in a company;
2) the regulator's staff;
3) financial intermediary organisations, including the staff of such organisations; and
4) other persons who are specified by the securities regulatory authority under the State Council.

The first tier of "insiders", who are corporate directors or other executives and majority shareholders, are subject to the "fiduciary duties theory". The second and third tiers of insiders generally owe duties to the source of the information; they are subject to the "misrepresentation theory". It seems that the last catch-all provision adds some uncertainty to the doctrine. Article 76 further expands the scope of "insiders" and sets out the tipper's liability. It elaborates on the legal duties of: (1) those "with knowledge of inside information" (the "insider" is defined by art.74); and (2) those "who have misappropriated inside information"—such persons are prohibited from: (a) purchasing or selling that company's securities; (b) disclosing such information without authority; or (c) suggesting that others should purchase or sell such securities, in each case at any time before such inside information is publicly disclosed.[13] In addition, the Securities Law stipulated tipper liability and fines in art.202, which says that if

> "[a corporate insider] divulges the relevant information or advises any other person to purchase or sell the securities before the information, which may have any substantial impacts on the price of the securities, is publicized, he shall be ordered to dispose of the securities as illegally held thereby according to law. A fine of 1~5 times the illegal gains shall be imposed. Where there are no illegal

[7] China first passed a Securities Law in 1998. See Zhonghua Renmin Gongheguo Zhengquanfa (Securities Law of the People's Republic of China) adopted by the Ninth Session of the Standing Committee of the Sixth National People's Congress, 29 December 1998, effective 1 July 1999. The Zhonghua Renmin Gongheguo Zhengquanfa 2005 (Securities Law of the People's Public of China 2005) was adopted by the 18th Meeting of the Standing Committee of the 10th National People's Congress, 27 October 2005, effective 1 January 2006 (Securities Law 2005). See Securities Law 2005 Ch.10arts 179–186.

[8] The Securities Law 2005 does not stipulate that the CSRC has the power to enforce the Company Law 2005. In practice, however, the CSRC enforces some Company Law doctrines, such as the director's duty of loyalty and the director's duty of diligence. See G.D. Xu, T.S. Zhou, B. Zeng and S. Jing, "Directors' Duties in China" (2013) 14 *European Business Organization Law Review* 57.

[9] For regulations that have been issued by the CSRC, see the CSRC's official website available at: *http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgz/* [Accessed 5 August 2016]. For a short English summary, see E. Sekine, "Complete Regulatory Overhaul of China's Capital Market Underway" (2011) 2 *Nomura Journal of Capital Market* 1.

[10] *SEC v Texas Gulf Sulphur Co* 258 F. Supp. 262 (S.D.N.Y. 1966); affirmed in part, reviewed in part, 401 F. 2d 833 (2d Cir. 1968) (en banc); cert. denied, 394 U.S. 976 (1969).

[11] *Chiarella v United States* 445 U.S. 222 (1980).

[12] *US v O'Hagan* 21 U.S. 642 (1997).

[13] This translation was made by Professor Howson: see N. Howson, "Punishing Possession: China's All Embracing Insider Trading Enforcement Regime" in Stephen M. Bainbridge (ed.), *Research Handbook on Insider Trading* (Cheltenham: Edward Elgar Publishing Ltd, 2013), p.327 at p.333.

gains or the illegal gains are less than 30,000 Yuan, a fine of 30,000 Yuan up to 600,000 Yuan shall be imposed".

The current regime seemingly expands the scope of insider trading liability compared with *US v O'Hagan*, which is particularly true of subs.2 of art.76, as it does not require the tipper to have a fiduciary duty to the source of information. Nevertheless, we should note that the US common law regarding insider trading has also developed in recent years. A defendant is not required to have a "fiduciary duty" to the source of information to be liable if the defendant acquired undisclosed material information using subjective deception. In *SEC v Dorozhko*,[14] the defendant appears to have hacked into a secure server at Thomson Financial Inc to gain access to the confidential third-quarter earnings of IMS Health Inc (which had hired Thomson Financial "to provide investor relations and web-hosting services"). Learning that the third-quarter results were highly unfavourable for IMS, the defendant then purchased short-term put options on IMS, which meant that the options would soon be worthless if IMS's stock price did not fall quickly. On this fact pattern, the defendant had no connection to IMS or to Thomson Financial and clearly owed no fiduciary duty to either. Nonetheless, the Second Circuit panel found that to the extent that the defendant had "deceptively" gained access to the material, non-public information, he had violated r.10b-5.[15] A substantial difference between the CSRC regulations and the *Dorozhko* case can nonetheless be drawn. As Professor Coffee indicates, *Dorozhko* extends the law of insider trading significantly, but it recognises that some element of deception must still be present for a defendant to violate r.10b-5.[16] However, subs.2 of art.76 does not require "deception", and the CSRC's enforcement also indicates that "culpable negligence" can constitute grounds for insider trading liability.[17]

To enhance the practicality of the law, the CSRC issued a *Guide for the Recognition and Confirmation of Insider Trading Behaviour in the Securities Markets (Insider Trading Guidance Provisions)*.[18] Article 6 of the regulations explicitly confirms that "those who employ illegal methods such as trickery, coaxing, eavesdropping, monitoring, secret trading etc. to gain inside information"[19] should be regarded as "insiders" and accordingly prevented from engaging in insider trading activities. Furthermore, the CSRC regulations set forth a broad catch-all provision—"those who gain inside information through other channels"—who should be regarded as "insiders". This provision fundamentally enlarges the scope of the CSRC's power with regard to insider trading violations. Subsection 2 of art.76 uses the term "misappropriated" (*feifa huoqu*), which, if we translate it directly, means "illegally acquire". Using this term, the prohibition that is set out by art.76 does not apply to a person who acquires information without breaking any laws, for example, a taxi driver hears a customer's phone call that mentions the potential takeover of a listed company. Given that he does not know his customer's identity, and he trades the company's stock based on this information, must he bear insider trading liability? In accordance with the securities law, the answer is "no", as the taxi driver did not breach any laws when he gained this information. The Interpretation of the Criminal Liability of Insider Trading by the Supreme Court sets out a clear standard of tippee liability when they are neither the relatives nor the friends of the tipper. The tippee must know or should know the identity of the tipper and the nature of the information.[20] In this hypothetical case, the taxi driver knows none of this information. Accordingly, the person who makes a phone call about the insider information will be not regarded as tipper. We should also note there is no interest exchange or any pre-existing economic relationship between the taxi driver and his customer. However, if we apply CSRC regulations to this case, the driver must be held liable. He actually gains "inside information through other channels" and trades the relevant stocks, although he does not misappropriate the information. As a result, it also imposes a tipper's liability to the customer. The CSRC regulations fundamentally alter the quasi-misrepresentation standard that was set out under the Securities Law. Using this catch-all standard, the CSRC adopts an "equal access information rule".

Given China's complicated and self-contradictory insider trading law regime, the question of how the CSRC can practically enforce this regime as a co-ordinated whole has become a fertile topic for research and debate. Using tipper liability as an example, our investigation into Chinese insider trading cases achieves two major findings: first, the standards used by the CSRC for insider trading are different from those used in the US, and tipper liability can thus be triggered by "negligence" in China,

[14] *SEC v Dorozhko* 574 F. 3d 42 (2d Cir. 2009).

[15] J. Coffee, "Mapping the Future of Insider Trading Law: Of Boundaries, Gaps and Strategies" (2013) 2 *Colombia Business Law Review* 281, 293. Rule 10b-5: "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."

[16] Coffee, "Mapping the Future of Insider Trading Law" (2013) 2 *Colombia Business Law Review* 281, 294.

[17] See section "The positive side—tipper liability enforced by the CSRC" below.

[18] Zhengquan shichang neimu jiaoyi xingwei rending zhiyin (*Guide for the Recognition and Confirmation of Insider Trading Behaviour*) issued by the CSRC in 2007.

[19] Translation by Professor Howson: see Howson, "Punishing Possession" in *Research Handbook on Insider Trading* (2013).

[20] See Guanyu banli neimujiaoyi xielu neimuxinxi xingshi anjian juti yingyong falv ruogan wenti de jieshi 2012 (Interpretation on Criminal Law of Insider Trading and Divulging Inside Information 2012) issued by China Supreme Court and China Supreme Procuratorate art.2(3): the tippee must have the following subjective knowledge: (1) understanding of the nature of the information, namely that the information is inside information; and (2) understanding of the source of information, i.e. the information is divulged by an insider or was obtained by a non-insider illegally.

where the subjective motivation of tippers can sometimes even be ignored. Secondly, in some cases, the CSRC enforces the law against both the tipper and the tippee, but in other cases with nearly identical facts, the CSRC does not hold the tipper liable. In short, it is difficult to summarise a set of stable standards by which the CSRC systematically enforces tipper liability.

The administrative enforcement of the tipper's liability

The positive side—tipper liability enforced by the CSRC

Can either "negligence" or "recklessness" be reasonable grounds for the CSRC to hold an insider liable? According to art.76 of the Securities Law, the insider or the person who has misappropriated insider information is generally prohibited from disclosing the material information or advising other parties to trade based on inside information, and there is no clear requirement for a subjective "*scienter*" or "fault". The *Kuang Yong* case is representative in that regard.[21] Mr Kuang was an executive of Geli Real Estate (Geli), which proposed that it be listed on the stock market by acquiring a listed company (namely, Haixing Technology) and then investing its core holdings in the target company. Following this type of back-door listing, the target company's share price will often increase in the short term. Mr Kuang's wife, Mrs Zhang, made substantial profits by purchasing the target company's shares before this information had been formally disclosed to the general public. In this case, Mr Kuang accepted that although he did not explicitly tell his wife that Geli would take over Haixing Technology's stocks, he had made business calls that contained substantial information about the takeover arrangement between Geli and Haixing Technology at home, and his wife could have obtained this information by overhearing his business calls. Furthermore, she also knew that Mr Kuang frequently made business trips to Xi An City, where Haixing Technology's headquarters were located. In this case, the CSRC held that Mr Kuang, as an executive of Geli, was fully involved in the takeover project between Geli and Haixing Technology and therefore comprehensively understood the prospective and potential business consequences of the project. Under such conditions, there is little doubt that Mr Kuang bears a fiduciary duty to the company and should have kept the information confidential. Therefore, when he did not take sufficient steps to protect the confidentiality of the information and leaked the information to his wife, he breached his fiduciary duties, and his conduct should thus be regarded as "divulging the relevant information", which falls under art.202 of the Securities Law. In this case, although no solid evidence shows that Mr Kuang deliberately advised his wife to purchase the target company's shares, they have common interests in sharing the insider trading profits, which belong to their marital property. In this sense, Mr Kuang had clear economic motivation to divulge the relevant information to his wife.

The CSRC further elucidates the standards regarding tipper liability by confirming that the "culpable negligence" of an insider can be grounds for tipper liability, even if the tipper has no clear economic motivation to advise the tippee to trade particular stocks. Mr Xiao was a director of Shanghai Xinri investment company (Xinri). Ningxia Hengli (Hengli) was a listed SOE in Ningxia Province that was undergoing restructuring. Xinri was invited to consult on the restructuring project and to make a substantial investment in the company. Mrs Zhu was Mr Xiao's wife, and she was informed by her husband that Xinri had invested in Hengli to facilitate its restructuring. Nevertheless, it seems that Mr Xiao had no economic motivation to encourage his wife to engage in insider trading activities. The reason is that Mr Xiao had previously invested nearly US $80 million in the listed company through the investment company that he controlled. Illegal insider trading by his family member would impose more potential risk on his investment in this project. When Mr Xiao learned that his wife was engaged in insider trading activities, he asked Mrs Zhu to sell the stocks immediately and returned all the profits to the listed company. In addition, he also resigned from his directorship. Even though Mr Xiao took substantial steps to minimise the negative effects of his wife's illegal activities, the CSRC nonetheless imposed fines on both the tipper and the tippee. First, the CSRC held that although Mrs Zhu was neither a senior executive of the company nor a participant in the restructuring project, she had obtained substantial information through her personal relationship. Under the Securities Law, she had misappropriated inside information. Secondly, Mr Xiao, who was one of the key participants in the restructuring project, should have borne the responsibility of confidentiality. It was "culpable negligence" (*zhongda guoshi*) to disclose the material information to his wife. Therefore, the fine was extended to Mr Xiao and his wife.[22]

Insider information is divulged not only in marriage but also in friendship. Mr Wu, a manager who worked in an investment institution, called his friend Mr Bao, who worked at Hongda Gufeng, a listed company, to inquire about the future market of precious metals. After finishing their discussion on this topic, Mr Wu asked: "Should I purchase Hongda Gufeng's stocks?" Mr Bao did not provide a "yes" or "no" answer directly; he said only: "No substantial risk." At the time, Hongda Gufeng was planning an important takeover action, which had the potential to raise its share price in the near future. Mr Bao, as the chief accountant of the company, was aware of the information. In this case, the CSRC held Mr Bao liable. It said that when Mr Wu inquired about the inside

[21] *Kuang Yong* 2010 No.32.
[22] 2012 No.22.

information, Mr Bao did not perform an acceptable level of diligence as a reasonable businessman should, and he divulged the inside information negligently, breaking the law.[23]

However, the result can be different when the degree of negligence is altered. Huaxing Chuangye (Huaxing) is a listed company that mainly develops computer software. To enlarge the company's business scale, Huaxing was preparing to take over several intelligent technology companies. Mr Cheng, as Huaxing's senior executive, was one of the primary participants in the takeover actions. The CSRC found that Mr Sheng, who was Mr Cheng's colleague, was engaged in insider trading activities. However, Mr Cheng denied that he had shared any inside information with Mr Shen, and there was no solid evidence to prove that such a communication had occurred. The CSRC found that Mr Shen's workstation was located next to Mr Cheng's office at a distance of less than one metre, which meant that Mr Shen could overhear Mr Cheng's business calls when he discussed the takeover actions with his business partner. Furthermore, Mr Cheng's computer screen was also within Mr Shen's range of vision, which meant that Mr Cheng could obtain confidential information as Mr Shen prepared the takeover documents on his computer. In this case, no fine was imposed on the tipper, and the CSRC punished only the tippee.[24]

The CSRC rarely reveals the reasoning process of its documents regarding administrative punishment on insider trading. Thus, we attempted to draw a map tracking the logic of the CSRC's enforcement approach in these four representative cases. It seems that they share one basic similarity, which is that the tippers conveyed sensitive information to the tippee. However, there are also significant differences in the degree of "negligence" in these cases. In the first case, there is a clear and strong economic motivation for the tipper to disclose the information to the tippee, as their jointly owned family assets would be upgraded by the insider trading activity. This case indicates that economic motivation is an important standard of tipper liability under the CSRC's jurisdiction. By contrast, in the other cases, there is no clear economic motivation for the tipper. However, as Professor Langevoort has indicated, greed is not the only motivation for insider trading. There are other considerations, such as cultural influence, failure to understand the law, and psychological bias.[25] In the second case, it is reasonable to expect that the tipper should foresee the potential risk of his wife's illegal activities when he divulged the information to her. Mr Xiao's disclosure to his wife reasonably gave rise to at least two foreseeable possibilities: she might be motivated by greed to risk insider trading and/or she might gain other benefits by passing such information along to related parties. In the third case, although Mr Bao did not explicitly tell his friend that the company was proposing a business activity that might increase the company's share price, he did inform Mr Wu that it was worthwhile to purchase the company's stock at that particular moment, as the profits of the investment overwhelmed the risk based on his insider knowledge. Mr Bao's activity can be regarded as "investment advice". Although this advice may be not have been intended to violate any laws, it is nonetheless prohibited by art.76 of the Securities Law. In the last case, it seems that Mr Cheng reviewed the business documents and made business calls about the takeover action in his office without much confidential protection, which can be described as non-culpable negligence. In other words, compared with the former two cases, it is far more difficult for Mr Cheng to be aware of or to predict that his colleague would misappropriate this information because he worked in his office. Under such conditions, whether "recklessness" can be viewed as solid grounds for tipper liability remains problematic because there is no "interest exchange" between Mr Cheng and Mr Shen.

The standards that applied to the second and third case (and probably also the first) are fundamentally different from US common law, which explicitly requires "deception and fault" as grounds for tipper liability. For example, in *SEC v Obus*,[26] the Second Circuit summarised the law on tipper liability under r.10b-5 as follows:

> "[A] tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper."

As we have discussed, at least in the case of Mr Xiao and Mr Bao, there was no solid evidence to suggest that the tipper passed the information on to the tippee for personal benefit.[27]

By contrast, a parallel to the Huaxing case can be found in US common law. In *SEC v Yun*,[28] a corporate executive and his wife were in the process of a divorce. She called her divorce attorney from her office to tell him that she had just learned from her husband that the stock and options that he owned through his employer were about to decline in value. The purpose of the call was to adjust the valuation of his assets for purposes of the divorce settlement. However, a colleague in the office overheard the negative news and quickly shorted the company's stock, profiting as a result. The SEC sued the executive's wife and her co-worker, probably because it realised that

[23] 2013 No.14.

[24] 2014 No.39.

[25] D. Langevoort, "What Were They Thinking? Insider Trading and the Scienter Requirement" in *Research Handbook on Insider Trading* (2013), p.52.

[26] *SEC v Obus* 693 F. 3d 276 (2d Cir. 2012).

[27] In US common law, the *Whitman* court further elaborates the above idea that "if the only way to know whether the tipper is violating the law is to know whether the tipper is anticipating something in return for the unauthorized disclosure, then the tippee must have knowledge that such self-dealing occurred, for, without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information": see *United States v Whitman* No.2-CR-125, 2012 U.S. Dist. LEXIS 163138 (S.D.N.Y. 14 November 2012).

[28] *SEC v Yun* 327 F. 3d 1263, 1273 (11th Cir. 2003).

it needed to prove a breach of fiduciary duties by the tipper to hold the tippee liable. Thus, the SEC alleged that the wife had "recklessly tipped her co-worker". In all likelihood, the SEC believed that the wife had tipped her colleague knowingly and deliberately as part of a longstanding pattern of their working relationship. However, the 11th Circuit dismissed the SEC's claim, and it held that the "recklessness" charge unfairly prejudiced the defendant and that such conduct by the tipper, when not motivated by any expected benefit from the tippee, was beyond the scope of r.10b-5. This case indicates that US insider trading law, r.10b and 10b-5 of the Securities Exchange Act, requires intention, which is a higher standard than negligence.[29] In the Huaxing case, the CSRC may have considered that no liability should attach to Mr Cheng because he simply leaked inside information solely as the result of incidental recklessness with no economic motivation. However, Mr Shen, as Huaxing's employee, did have a fiduciary duty to the company, and he also had clear knowledge of the source of the information. Thus, he was liable when he breached that fiduciary duty by engaging in insider trading.

Unlike the US common law on insider trading, which draws a clear line between "deception" and "negligence", the CSRC's approach to tipper liability is a more complicated combination of different standards, including the insider's motivation, state of mind and level of negligence. The line between negligence and *scienter* is blurred by these standards. From the above cases, it seems that beyond the US-style "*scienter* requirement", a "clear economic motivation" (Mr Kuang and Mrs Zhang), "culpable negligence" (Mr Xiao and Mrs Zhu, and Mr Bao and Mr Wu) can be grounds for tipper liability. In other words, only if an insider's information leak can be proved to be caused only by slight negligence and without clear economic motivation will the CSRC relieve tippers of liability (as in the case of Mr Shen and Mr Cheng). Consistent with the Securities Law and administrative regulations, the CSRC seems to broadly enforce tipper liability. However, it remained an open question as to whether these standards were applied by the CSRC consistently to all insider trading cases when we investigated the CSRC's enforcement of tipper liability on a macro level.

The negative side—tipper liability ignored by the CSRC

Although the CSRC made some significant achievements in enforcing tipper liability in insider trading cases, it continues to have significant weaknesses. CSRC enforcement is inconsistent at best. In a 2013 case, Mr Su was a corporate executive of a listed company who learned that a foreign investor would soon make substantial investments in his employer. He disclosed this information to his wife, and his wife profited from trading the company's stock. This case can be compared with Mr Xiao's case, which was discussed above. The key facts of these two cases are similar: a husband tipped off his wife. However, compared with Mr Xiao, it seems that Mr Su's motivation for tipping was stronger, and he did not try to minimise the negative results of the insider trading. Strikingly, the CSRC's judgment in Mr Su's case was different, and it fined only the tippee and not the tipper.[30] This result is hardly fair for other tippers who were fined under similar conditions. Furthermore, the "negligence standard" that has been set out by the CSRC was challenged on its face. Mr Zhang was a corporate executive of a listed company. The parent company of a corporate group proposed an investment in some high-quality assets in the listed company. Under these circumstances, Mr Zhang called his friend and told him this inside information. However, in this case, the CSRC relieved the tipper of liability, as the "leak of information in this case is only a slight negligence".[31] This decision is difficult to follow as well, and is difficult to align with the case in which the insider made only the merest hint to his friend and was found to be liable.[32]

The problem is even more serious in other cases. Sometimes there is a clear interest exchange relationship between tipper and tippee, and the CSRC does not punish the tipper. Henan Senyuan is a listed company that was obligated to disclose its major profit growth in its quarterly report. Before this information was disclosed to the general public, Mr Chu, who controlled Henan Senyuan, passed this information on to Mr Qi and Mr Zhang. These two persons were business partners of Mr Chu in another business entity. In this case, the CSRC punished only the tippees, who made substantial profits. From a subjective perspective, it is not difficult to discern the tipper's motivation to convey the information to his business partner, and he deliberately breached his fiduciary duties to his employer.[33] Similar cases are not difficult to find. For example, the CSRC once found that the tipper was the financial consultant of the tippee's company, and the tippee frequently paid service fees to the tipper. Under such an interest exchange relationship, when the corporate insider tipped his business partner, the CSRC did not fine the tipper.[34] A recent extreme example is the case of Mr Liu, who was an executive of a listed company who deliberately disclosed important

[29] Coffee, "Mapping the Future of Insider Trading Law" (2013) 2 *Colombia Business Law Review* 281, 291
[30] 2013 No.51.
[31] 2013 No.16.
[32] 2013 No.14.
[33] 2013 No.21.
[34] See 2014 No.36; for a similar case, see 2012 No.31.

inside information to three of his friends, and the CSRC did not hold him liable.[35] From 2010–14,[36] there were 27 cases[37] in which the CSRC punished only the tippees and not the tippers.

Ignoring tipper liability causes a serious logical problem in a technical sense. As discussed above, US common law requires that the tipper and tippee must be part of a de facto conspiracy in which the tipper breaches his or her fiduciary duty by deliberately communicating the material information to benefit the tippee either: (1) in return for an economic benefit conferred by the tippee on the tipper; or (2) as a gift.[38] Recently, this doctrine was further developed in *SEC v Obus*. The court defined tippee liability as follows:

> "Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tipper improperly obtained the information (i.e., that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material, nonpublic information, used the information by trading or by tipping for his own benefit."[39]

The above legal standards contain two important pieces of information. First, it seems that even if the tipper does not receive any benefits from the tippee, the tippee would be responsible for breaching insider trading law when solid evidence shows that the tippee knew or had reason to know that the tipper breached his fiduciary duties by disclosing the material information. This approach has been adopted in most of the CSRC's enforcement actions on insider trading. Secondly, and more importantly, a clear connection between tipper liability and tippee liability appears to have been established. One of the pre-conditions of tippee liability is that the tipper breaches his fiduciary duties to his employer when he passes the information to the tippee.

Consequently, the CSRC's enforcement of tipper liability has a major flaw in that it is inconsistent. It uses random legal standards for tipper liability in the insider trading cases. This flaw leads to at least two negative results. First, both art.7 and art.178 of the Securities Law require the CSRC to regulate the securities markets in accordance with the laws. Under such conditions, inconsistent enforcement of the law calls into question the CSRC's purported legality as a neutral regulator. The CSRC has been suspected of abusing its administrative power on behalf of various types of market participants. The second negative result is that in a legal technical sense, circumventing tipper liability in insider trading cases triggers a serious logical problem. Tippee liability is triggered by the tipper's breach of fiduciary duties. If the CSRC silently accepts that the tipper is not liable for breaching its fiduciary duties, it means there is no legal basis for the CSRC to hold the tippee liable.

The implications of tipper liability in the context of China

Although the standards that have been adopted by the CSRC appear to be random, the implications of this phenomenon can be illuminated from different perspectives. There are at least three major reasons for the random standards of tipper liability: unconstrained administrative power, difficulties in collecting evidence, and senior officials' corruption.

Unfettered administrative power

Although China's Administrative Procedure Law 1988 authorises the court system to review the CSRC's decisions, this regime does not work well in practice. The Beijing First Intermediate Court and the Beijing High Court are the two courts that have jurisdiction over the CSRC's administrative decisions. From 2008–15, these two courts accepted 39 cases in which the defendant was the CSRC. However, the court held that the CSRC's administrative decision was illegal in only one of those 39 cases.[40] Thus, private parties have only a 3% chance to win a case when suing the CSRC. Furthermore, in the one case that was won by a private party, the court set aside the CSRC's decision on procedural grounds, i.e. the court did not review the CSRC's decision substantively. It has long been argued that in terms of securities law enforcement, the court system in China is a subject of the administrative organ. In accordance with the Supreme Court's Notice,[41] private securities litigation is dependent upon administrative and criminal sanctions. In other words, aggrieved investors can commence civil litigation only against a party who has received an administrative fine from the CSRC or another administrative organ such as the Ministry of Finance on the basis of fraudulent disclosure, or who has been convicted of the crime of misrepresentation by a court. Arguably, these preliminary requirements reduce the cost of evidence collection for private investors while also keeping a check on the floodgates of litigation. Some economic studies have also indicated that the market regulator outperforms courts as a law enforcer when the

[35] See 2013 No.18; 2013 No.19; 2013 No.20; 2013 No.21.
[36] We also investigated all the accessible cases before 2010. However, there was no insider trading case that involved tipper liability.
[37] The case numbers are 2011 No.47; 2011 No.51; 2012 No.23; 2012 No.31; 2012 No.52; 2013 No.13; 2013 No.16; 2013 No.18; 2013 No.19; 2013 No.20; 2013 No.21; 2013 No.35; 2013 No.41; 2013 No.51; 2013 No.63; 2013 No.65; 2013 No.66; 2013 No.72; 2014 No.2; 2014 No.9, 2014 No.29; 2014 No.36; 2014 No.37; 2014 No.43; 2014 No.53; 2014 No.63; 2014 No.74.
[38] *Dirks v SEC* 463 U.S. 662 (1983).
[39] *SEC v Obus* 639 F. 3d 289 (2d Cir. 2012).
[40] The only case in which the CSRC defeated is (2014) Gao Xing Zhong Zi No.3699.
[41] Zuigao renmin fayuan guanyu shouli zhengquan shichang yin sujia chengshu yinfa de minshi qinquan jiufen anjian youguan wenti de tongzhi (*The Notice on Relevant Issues Concerning Accepting Civil Tort Dispute Cases Caused by False Statement on Securities and Several Provisions on Hearing Civil Compensation Caused by False Statement on the Securities Market*) (the Notice) issued by China's Supreme Court on 15 January 2002.

"costs of verifying the circumstance of specified cases and interpreting statutes are high".[42] However, the fact that the right of an individual investor to a civil claim is partially controlled by the administrative authorities is still problematic from the perspective of procedural fairness. In practice, enforcing an investor's private claim is tightly restricted by the attitude of the administrative organs towards the fault that is disclosed. It can also be argued that the CSRC—an administrative regulatory body—might adopt different standards to justify whether a disclosure is fraudulent from those tests that are used by a court in hearing civil litigation. In short, securities law enforcement in China is oriented towards the administrative power. For reasons connected with the above phenomena, Professor Clarke provides an insightful explanation. He argues that:

> "The Chinese state prefers direct regulation by government agencies first, and indirect regulation by private litigation in the state's courts next. Regulation by the uncontrolled institutions of the market comes a distant third, and indeed it is hard to find such institutions in China."[43]

To protect publicly listed SOEs, the state endows the CSRC with power that is not subject to outside checks and balances. The court system in general is reluctant to second-guess the CSRC's administrative decisions. Consequently, it is understandable that the CSRC can use random standards regarding tipper liability in accordance with its preferences.

Difficulties in collecting evidence

Selective enforcement is a more cost-efficient enforcement strategy than complete enforcement for regulator. The senior officials of the CSRC have admitted that they have considerable difficulties in collecting evidence. A cause–effect relationship between undisclosed information and insiders' trading behaviour is often difficult to prove. Generally, the CSRC will observe three criteria, namely, a "sensitive period",[44] a "sensitive identity"[45] and "sensitive behaviour". Compared with the first two criteria that have been explicitly elaborated by relevant laws, "sensitive behaviour" can be divided into two sub-standards, the pre-existing relationship between the trading account and an insider, and deviation from the standard course of dealing. The first standard indicates that the relationship between the securities accounts that are involved in the suspected trading and the insider should be a close one. In many cases, insiders use their relatives' or friends' accounts to engage in insider trading. The second standard indicates that the transaction itself should be sufficiently abnormal, particularly compared with the insider's normal course of transaction activities. This sub-standard itself consists of two important parts. First, the suspected trading should be considerably different from the normal trading model of the insider. For example, a relative of a listed company's director typically trades securities with sufficient caution. From his trading record, the regulator concludes that he is a risk-averse trader. However, in the suspected trading, the insider's trading strategy is far more aggressive, e.g. purchasing a large quantity of stocks over a short period, which indicates a deviation. Secondly, the fundamentals of the company are also a key test. Given that the public information of a listed company indicates that the company's business and trading activities have not experienced significant improvements and, accordingly, share prices are neither under- nor over-valued, it can be regarded as abnormal when an insider purchases a large quantity of stock at a particular moment. It is assumed that the CSRC may have difficulties in collecting evidence about the chain of information between the tipper and the tippee. For example, Mr Ouyang Jiansheng was the vice-director of the CSRC's Inspection Department, which took over insider trading violations in 2012. He once told a journalist that inspecting corporate insiders had become increasingly challenging in recent years, that the chain of insider trading was difficult to determine, and that the most difficult part of an insider trading case was to find where the information came from and how the information was communicated.[46] In this particular area, the only evidence that the CSRC can typically gather is communication by phone call or physical meetings between tippers and tippees. However, the content of the calls or meetings can be confirmed only by the confession of either the tipper or tippee. A tippee is highly unlikely to confess his violation, as he will undoubtedly be punished by the CSRC because the tippee takes active action to engage in insider trading and typically profits from this activity. By contrast, the tipper may be a weak link in this chain, and accordingly has a stronger motivation to confess. In some cases, the tipper only passes the information to another party, but he does not directly trade based on the inside information or exchange interests with the tippees. When the CSRC struggles with evidence, it may give preferential treatment to the tipper if he is willing to confess the contents of his communications with the tippee. Therefore, the tippers may be relieved from liability in such cases.

Difficulties in collecting evidence are associated with the limited resources allotted to the CSRC. The director of the CSRC, Mr Xiao, claims that the dramatic increase in securities violations, particularly in insider trading

[42] G. Edward, S. Johnson and A. Shleifer, "Coase v. Coasians" (2001) 116(3) *Quarterly Journal of Economics* 853.
[43] D. Clarke, "The Ecology of Corporate Governance in China", GWU Legal Studies Research Paper No.433 (2010), p.57, SSRN available at: *http://ssrn.com/abstract=1245803* [Accessed 5 August 2016].
[44] The sensitive period indicates the period from the time that the inside information is formulated to the time that it is formally disclosed. See art.5 of *Interpretation of Criminal Law of Insider Trading and Divulging Inside Information* issued by the China Supreme Court and China Supreme Procuratorate in 2012.
[45] See Securities Law 2015 art.74.
[46] See Neimu jiaoyi chengxian duoyuanhua tezheng (*The Diversified Insider Trading, An Interview of Mr OuYang*) available at: *http://finance.qq.com/a/20120912/001307.htm* [Accessed 5 August 2016].

cases, has placed substantial pressure on the CSRC. He admitted that there is no effective incentive for officials to enforce the law, and the CSRC's enforcement department has limited resources to fight against the rapidly growing number of securities violations. He further indicated that the CSRC had only approximately 600 law enforcement officers in 2013, compared with the SEC's 1,236 law enforcement officers at the same time: see fig.1.[47] Mr Xiao failed to mention that the CSRC's budget is also far less than that of the SEC.[48]

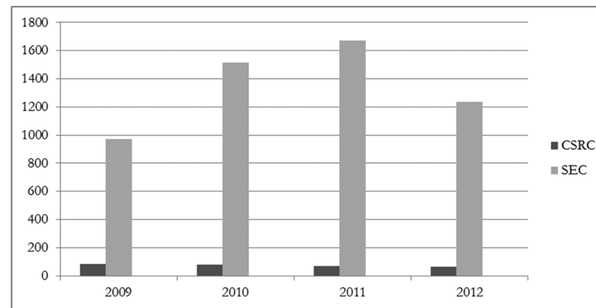

Figure 1: Regulatory budgets (inputs) from 2008–12 (million US $), CSRC and SEC

Senior official corruption at the CSRC

The random standards associated with tipper liability and unequal treatment may be a byproduct of corrupt CSRC officials. Mr Ouyang, who was the vice-director of the CSRC's Inspection Department in 2012, was arrested by the police for assistance in insider trading and the falsification of a public seal in 2015. Mr Ouyang's colleague, Mr Liu, also made millions of RMB in illegal profits from insider trading and by granting preferential treatment to listed companies. According to media reports, 12 CSRC officials were arrested on corruption charges from 1994–2014.[49] Recently. the CSRC vice-president, Mr Yao Gang, and both his assistant, Mr Zhang Yujun, and former assistant, Mr Liu Shufan, were arrested in November 2015. Mr Yao was in charge of the initial public offering (IPO) procedure in China's securities markets for nearly 12 years.[50] Although there has been no public announcement of Mr Yao's illegal activities, some reports have indicated that Mr Yao's wife was a successful lawyer who was a senior partner in one of China's pre-eminent law firms. Not surprisingly, in recent years, this law firm has enjoyed a great record in IPO-related business.[51] Furthermore, Mr Liu Shufan, who was arrested in 2014, engaged in insider trading by approving a public company's proposed private placement of securities, and passed this information on to one of his friends, making an RMB 3 million profit through insider trading. Furthermore, by approving this private placement and maintaining the share price of this public company, Mr Liu received a large amount of bribes (several million RMB) from private parties. Given the above information, it is understandable why CSRC enforcement of insider trading has lacked basic consistency. The officials are corrupt, and they use their power of enforcement for profit. A similar conclusion has been drawn by Liebman and Milhaupt, who argue that

> "the CSRC rarely punishes insider trading cases with huge amounts of money, the number of [CSRC] sanctions seem to be rather modest given the ubiquity and severity of the problems with … insider trading … in China's stock markets. Some evidence found that even the CSRC's officials themselves are engaged in insider trading".[52]

Conclusion

The above research provides sufficient evidence to illustrate important characteristics of CSRC enforcement, which can be unpacked from a comparative perspective. First, the CSRC's standards for insider trading are broader than those that have been adopted by the US, namely, there is no requirement of deception. In other words, insider trading liability can be triggered by negligence. Secondly, it seems that the CSRC has been endowed with unconstrained power that enables it to enforce tipper liability in insider trading cases by random standards. In short, the CSRC's enforcement of insider trading is not always based solely on the relevant legislation. This research further explores the implications behind CSRC enforcement of insider trading. Three major constraints may lead to this phenomenon: the absence of judiciary review, difficulties in collecting evidence, and official corruption. Once again, this research proves the dysfunction of the regulator in enforcing laws and

[47] G. Xiao, "Jianguan Zhifa, Ziben Shichang Jiangkang Fazhan de Jishi (Enforcement of Regulation: The Cornerstone of Prosperous Stock Markets)" (2013) 15 *Qiushi (Truth Seeking)* 31.
[48] For more comprehensive data, see T.S. Zhou, "Is the CSRC Protecting a 'Level Playing Field' in China's Capital Markets: Public Enforcement, Fragmented Authoritarianism and Corporatism" (2015) 15(2) *Journal of Corporate Law Studies* 377.
[49] "Zhengjianhui lizhi guanyuan she neimujiaoyi (*The Retired CSRC Officer is Suspected of Insider Trading*)" available at: *http://business.sohu.com/20150826/n419739178.shtml* [Accessed 5 August 2016].
[50] "Yaogang an xin baodao (*The Case of Yao Gang*)" available at: *http://mycaijing.com.cn/news/2015/11/16/141013.html* [Accessed 5 August 2016].
[51] In accordance with Chinese Securities Law 2015, a pre-IPO company must employ lawyers as sponsors to prepare their legal documents for the IPO. See Securities Law 2015 art.11.
[52] Liebman and Milhaupt, "Reputational Sanction in China's Security Market" (2008) 108 *Columbia Law Review* 929.

regulations. Under such conditions, judicial intervention may be expected to play a more important role in enforcing securities law in China.