

# *Controlling insider dealing through criminal enforcement in China*

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# Controlling Insider Dealing Through Criminal Enforcement in China

Zhen Ye<sup>1</sup>, Wangwei Lin<sup>2</sup>, Neshat Safari<sup>3</sup>, Charanjit Singh<sup>4</sup>

## Abstract

**Purpose** -The enforcement of the new Securities Law (SL 2020) of the People's Republic of China (PRC) in March 2020 presents a perfect opportunity to review the criminal enforcement of insider dealing cases in China's securities market and to provide feasible suggestions for improvement for a more coherent and streamlined insider dealing regulatory framework in the PRC.

**Design/approach** -Through analysing the previous literature on public interest theories and economic theories of regulation, this article examines the necessity to regulate insider dealing in China with criminal law to ensure fairness and avoid monopolies in its securities market. The article reviews the criminalising of severe insider dealing cases in China from the Nanking National Government in the 1920s to the inception of the securities market of the PRC in the 1990s to the present day. The investigation, prosecution, enforcement, and trial of criminal offences of insider dealing in China are thoroughly examined.

**Findings** - The article finds a tendency for over reliance on the investigation and the administrative judgement of the China Securities Regulatory Commission (CSRC) in criminal investigation, prosecution, and trial in the PRC.

**Originality/value** - The article is one of the first articles to critically and thoroughly analyse the criminal enforcement of insider dealing in China following the recent enforcement of China's new Securities Law in March 2020.

**Keywords** Insider Dealing, Criminal Enforcement, China, Securities Market, Financial Regulation

**Article classification** Scholarly Article/ The construction or testing of a model or framework

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## Introduction

A financial market has a variety of functions, such as effectively diversifying investment risks and optimally allocating resources. Of all the factors that contribute to the fulfilment of such functions, the market's reputation for integrity is one of the most important; however, this may be severely undermined by financial misconduct, which subsequently has a negative impact on the economy as a whole. Insider dealing as an example of such misconduct is not new. It occurs when a person uses privileged material information obtained by virtue of his or her position to trade in the subject securities. It is argued that those in positions of trust, such as directors, officers, and beneficial owners, not only dishonestly advance their own interests by using non-public price-sensitive information, but they also jeopardise the interests of uninformed investors, since they are put at an unfair disadvantage. This leads to a loss of confidence in the integrity of financial markets.

The significance of the securities markets in China in the development of the economy cannot be overestimated. However, the importance of these markets is not limited to their role as allocators of capital resources. The markets are vital vehicles for the Chinese in the path to a new economy where market forces are acknowledged and given a degree of respect that would have been unimaginable even just 30 years ago.<sup>5</sup>

To ground the article firmly in the study of criminal law, we initially concentrate on the various theories that have been developed to justify the intervention of law in the creation and maintenance of viable and efficient markets. This is of real and practical significance to policy makers in China, as the role of the law is still not as obvious as it might be in more established mixed economies. We then focus specifically on the justifications for criminalising insider dealing and the evolution of the criminal enforcement of insider dealing in China from the Nanking National Government in the 1920s up to the present day. The present regulatory system being developed tends more to address perceived issues of international compliance than perhaps the realities of the Chinese markets. We then look in some depth at the criminal sanctions imposed on insider dealing and its prosecution, trial, and enforcement in China. Next, we consider how best to address the weaknesses that have been identified in the Chinese regime in the hope of assisting in a more efficacious approach to the enhancement of legal deterrence and the promotion of market integrity.

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<sup>5</sup> On 24 July 1984, Beijing Tianqiao Department Co. Ltd., the first share-holding company, was incorporated after such practice disappeared in China for decades: CSRC, *China Securities Regulatory Commission Annual Report 2007 (2011)* <[http://www.csrc.gov.cn/pub/csrc\\_en/about/annual/200812/P020090225529643752895.pdf](http://www.csrc.gov.cn/pub/csrc_en/about/annual/200812/P020090225529643752895.pdf)> accessed 10 May 2020.

## **Public interest theories and economic theories of regulation as a theoretical basis for regulating insider dealing**

Using the tool of marginal utility analysis, welfare economists link government intervention with market imperfections and social welfare. Theories of regulation originate from the public interest theories of welfare economics (Hale, 1987; Domas, 2003). Pigou (1952) suggests that when there is a negative externality and when the 'marginal net social product is less than marginal net private product', government intervention, especially a tax, is required. Pareto argues that good government intervention should not only contribute to the increase in the overall welfare of society, but it should also ensure that the welfare of any individual will not be worse (Francis, 1993). Kaldor and Hicks expanded Pareto's theory, proposing that if those who are made better off can pay sufficient compensation to those who are made worse off and improve the welfare of both, it is likely to result in a Pareto optimal outcome (Fujimura and Weiss, 2000).

Public interest theories have received wide acceptance (Baldwin and Cave, 1999). They aim to show that markets are not only fragile but also operate with imperfect competition, thereby allowing monopolies, externalities, and imperfect information. Imperfect competition leads to market failure, which can reduce social welfare and the efficiency of resource allocation (Ogus, 1994). Consequently, public interest theories argue for the necessity of regulation from a normative perspective, that is, to rectify market failures, increase the efficiency of resource allocation, and maximise social welfare. However, not all authors agree that public law should be the first choice in ratifying market failures. Ogus, for example, astutely argues that private law and market instruments should be the first choice; only when 'market failure' coincides with 'private law failure' can there be a prima facie case for government intervention in the public interest (Buckle and Thompson, 2004, p.12).

Public interest theories have been criticised for not taking into account the possibility of regulators being influenced by personal interests or being effectively 'captured' by those who are set to supervise. This criticism has led to the development of economic theories of regulation (Stigler, 1971, pp.1-3). Posner argues that regulation is actually a device used by politicians to seek favoured votes and other contributions from those who will receive valuable benefits from them in return (Posner, 1974). According to research on regulatory development in the US, Stigler concludes that regulation is likely to be implemented to serve the needs of the regulated industry, especially specific-interest groups within the industry (Stigler, 1971, pp.1-3).

Since its re-emergence in the late 1980s China's securities market has been subject to prudential regulation in which the government has played a dominant role in order to protect the interests of investors and promote the public interest. It seems to suggest that public interest theories have largely been advocated by the legislators. However, the government has been criticised for overregulating the markets and, in fact, replacing the market mechanism with significant influence over the market prices of securities. China's securities market is thus also called a 'policy market' (Peng and Xiao, 2002; Pan and Mei, 2002). This special role of the government in China's securities market has not only been widely criticised by ordinary investors and researchers but has been viewed as being responsible for the prevalence of insider dealing in China (Li and Tan, 2010). Thus it seems at least arguable that economic theories of regulation also have a role to play in China's securities regulations.

If the regulation is likely to be implemented to serve the needs of the regulated industry as Stigler found, and it could serve as a device used by politicians to seek favoured votes and other contributions from those who will receive valuable benefits from them in return as Posner argued, it is then essential to find ways to distance the regulation and enforcement from the regulators of the industry in question to avoid the potential 'revolving door' situation. For the securities market, more specifically for insider dealing cases, one of the methods could be imposing criminal sanctions on insider dealing cases so that the prosecutors and the courts can take the lead on the sanction instead of the securities regulators, which would be the CSRC, the designated regulator of the securities markets under the State Council in the context of China.

### **Criminalising severe insider dealing cases in China**

Prior to the inception of the People's Republic of China, the Nanking National Government enacted two Criminal Acts in 1928 and 1935 respectively, which contained a number of provisions concerning insider dealing.<sup>1</sup> Article 335 of the Criminal Law 1928 could be read as imposing insider dealing liability on tippees (any unauthorised person who disclosed 'the industrial and commercial secret' obtained by virtue of his or her employment), punishable by up to one year's imprisonment, criminal detention, or a fine of up to 1,000 Yuan. Article 317 of the Criminal Law 1935 further prohibited any person who was obliged to keep industrial and commercial secrets he or she knew or had obtained in accordance with the law or contract from leaking such information without legitimate reason; any contravention was punishable by up to one year's imprisonment, criminal detention, or a fine of not more than 1,000 Yuan. Article 318 doubled the maximum prison term and amount of fine if the offender was a public servant or ex-

public servant in possession of information gained by virtue of his or her current or previous office. After almost half a century, the securities markets in China were gradually reduced and eventually disappeared as a result of the establishment of a highly centralised economic structure that had heavily relied on administrative management since 1949 (CSRC, 2008).

It was not until the early 1980s that they re-emerged thanks to a great many structural reforms, economic as well as political, that had been taking place since 1978 (Li, 2008). The unfortunate corollary of the rapid growth of China's economy, however, had been an increasing amount of insider dealing, which became a target of central government enforcement in order to maintain public confidence in the integrity of the markets from the end of the 1980s.

Proceeding from efforts made by local governments, the State Council (SC) and the Securities Committee of the State Council (SCSC), at central government level, brought in the Interim Provisions for the Management of the Issuing and Trading of Stocks 1993 (IPMITS 1993) and the Interim Measures on Prohibition of Securities Fraudulent Conducts (IMPSFC 1993). Criminal and civil liabilities were touched upon lightly in articles 77–78 of the IPMITS 1993 and article 13 of the IMPSFC 1993. Despite the good start provided by the above regulations, it was still some considerable time before insider dealing was pronounced a criminal offence. The next legislative effort was article 147 of the Company Law 1993, which prohibited sponsors of a company from transferring their shares within three years of the date of the company's incorporation, and obliged directors, supervisors, and managers to file an ownership report and prohibited them from transferring shares during their term of office.

With the high incidence of market manipulation, insider dealing, fraud, misrepresentation, and other irregularities, China's securities markets in the late 1990s were in a state of chaos. The situation called for the urgent enactment of a unified securities law. In 1996, an Advisory Committee was appointed by the CSRC, consisting of Professor Barry Rider, Mr Tom Newkirk, (the Deputy Head of the then Enforcement Division of the US Securities and Exchange Commission), a leading US securities lawyer, and the Chairman of the Australian Stock Exchange. Finally, after a number of years on the drawing board, the Securities Law 1998 of PRC (SL 1998) came into effect.

The Criminal Law 1997 of PRC (CL1997) replaced the Criminal Law of PRC 1979 and made insider dealing a criminal offence. Article 180, which criminalises insider dealing, has been revised twice, first by Amendment I 1999 and then by Amendment VII 2009 to the CL 1997, and represents an extension of criminal liability for insider dealing. Most notably, Amendment VII 2009 enables business units, corporate persons, and certain practitioners working for financial intermediaries to be the subjects of insider dealing crime. The business units and corporate persons will be fined, and the personnel directly responsible will be sentenced to up to five years in prison. Practitioners working for financial intermediaries, such as stock exchanges, future exchanges, securities companies, future brokers, fund management companies, business banks, and insurance companies, are also included in the list of ‘insiders’ by Amendment VII 2009.

In 2012, the Supreme People’s Court of China (SPC) and the Supreme People’s Procuratorate (SPP) promulgated the Interpretation of Certain Issues Related to the Specific Application of Laws in Handling Criminal Cases Involving Insider Dealing and Divulgence of Insider Information 2012 (IID 2012), which provides further guidance on specific issues of insider dealing offences.

Article 180 of the CL 1997, para. 1 provides for two offences of insider dealing that prohibit individuals and entities from engaging in three classes of conduct in specific circumstances. The first offence is that of *dealing* on inside information. A person in possession of inside information as an insider, whether his or her possession is legal or illegal, is guilty of insider dealing if he deals in price-affected securities or futures based upon inside information prior to its disclosure. The second offence relates to *disclosing* inside information. This has two limbs: (1) disclosing inside information to another person, and (2) encouraging, expressly or impliedly, another to deal on the inside information or to disclose the information. In order to constitute an offence of insider dealing, as well as other crimes, under the CL 1997, four elements must be satisfied: (1) an individual or unit must have information as a ‘person in possession of inside information’ or an ‘illegal obtainer of inside information’; (2) the information possessed must be inside information; (3) the insider must have engaged in prohibited insider dealing activities; and (4) the suspected insider dealing must be conducted intentionally, meaning that the insider has clear knowledge of the consequence of his or her activities.

Criminal liability for each offence of insider dealing attaches not only to individuals but also to business units or other legal persons, such as unincorporated associations, partnerships, or firms comprising a group of individuals. Although the CL 1997, article 180, para. 1 and the IID 2012, article 1 define an ‘insider’ as a ‘person with knowledge of inside information on securities and futures trading’, which excludes business units or other legal persons, the CL 1997, article 180, para. 2 and the IID 2012, article 11 state that when a business entity commits any offence of insider dealing and falls within any of the circumstances in the IID 2012, article 6, the entity shall be liable for insider dealing. Therefore, criminal liability for insider dealing offences may attach to both individuals and legal persons. Depending on the gravity of the violation, the penalties for insider dealing offences range from imprisonment or detention of no more than five years and/or a fine of one to five times the profit gained or loss avoided, to imprisonment of between five and ten years and a fine of one to five times the profit gained or losses avoided. If the offender is a business unit, those who are directly in charge of the business are liable to imprisonment or detention of not more than five years. In a case where insider dealing is committed by multiple defendants, each defendant shall be convicted and punished according to the cumulative value of the securities traded, the security deposit occupied, and the profit gained or the loss avoided, while the fine imposed should not exceed five times the illegal profits. In cases where insiders have not actually made any profits from the unauthorised disclosure of inside information to a third party or from encouraging that party to trade in the affected securities, article 10, para. 2 of the IID 2012 states that the amount of the fine imposed shall be determined according to the value of the profit gained or loss avoided by the beneficial party of the inside information who engaged in insider dealing activities based on the information.

There are provisions in the IID 2012 to the effect that no person may be subject to criminal penalties for violation of article 180, para. 1 of the CL 1997 if it can be proved that the trading in question was pursuant to a legal agreement or any other means of purchasing shares of a listed company, written contracts, instructions, or plans made in advance or if the information has been made publicly available.

### **Prosecution of criminal offences of insider dealing in China**

In China, the Prosecution Services, also known as the People’s Procuratorates (PPs), have acquired exclusive power under the 1982 Constitution, the CL 1997, and the Criminal Procedures Law to prosecute the cases transferred by the Public Security Organs of China (PSOs) following



a criminal investigation. Prosecution of insider dealing has not had a long history in China, as insider dealing was not criminalised until 1997, and it was not until 2003 that the first case was brought successfully under article 180 of the CL 1997.

In this first insider dealing case, namely, the *Shenshen Fang* case, two defendants, Mr Huanbao Ye and Ms Jian Gu, were subsequently convicted of insider dealing and sentenced to three and four years' imprisonment respectively, and Gu's illegal gains were confiscated. The case was widely welcomed as the first criminal prosecution of insider dealing under article 180 of the CL 1997.

In 2010, the PP of Nantong City of Jiangsu Province charged Mr Baochun Liu, at that time the Director of the Economic Committee of Nanjing Municipal Government, and his wife, Ms Qiaoling Chen, with insider dealing under article 180 of the CL 1997. The case attracted widespread attention because it was the first insider dealing prosecution against a government officer. The Intermediate Court of Nantong found that Liu had inside information by virtue of his post in the Nantong Municipal Government and subsequent appointment to participate in the project of the reconstruction of a listed company as an insider within article 74 of the SL 2005 (now article 51 of the SL 2020). He violated insider dealing prohibitions under article 73 (now article 50 of the SL 2020) of the SL 2005 and article 180 of the CL 1997 by willingly and knowingly disclosing the information to his wife and trading in the affected securities. He was sentenced to five years' imprisonment and fined 760,000 Yuan for insider dealing. His wife was also convicted of insider dealing but received only an order for the confiscation of her illegal gains without any imprisonment, as the court considered her an accessory in the insider dealing conspiracy.

As in other countries, prosecution of insider dealing in China has never been an easy task. Even so, the Amendments I and VII of the CL 1997 had been powerful weapons against insider dealing offenders, and the introduction of the IID 2012 provides a practical guideline for the PPs to prosecute offenders, whether individuals or companies, for their abuse of inside information.

## **Investigation and court trial of insider dealing criminal cases in China**

In 1998, the promulgation of the long-awaited Securities Law with specific insider dealing provisions and Criminal Law amendments might have justified the expectation of vigorous enforcement by the government to deter insider dealing. Two decades on, it is fair to say that China has taken steps to build up the regime of inside dealing regulation with the assistance of overseas experience, and its desire to tackle insider dealings should be recognised and applauded.

On the one hand, the SC has prioritised combating insider dealing. In a 2010 Opinion on Combating Insider Dealing Cases in Capital Market in Accordance with the Law (Opinion 2010), multiple government agencies, including the CSRC, the Ministry of Public Security (MPS), and the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) were required to cooperate and to tackle insider dealing activities that had become ‘more hidden and complex since the trading launch of stock index futures’ together. <sup>ii</sup>

Pursuant to the Opinion 2010, insider dealing has become a high priority for the enforcement programme of the CSRC. An enhanced relationship between the CSRC and two stock exchanges and the Economic Crime Investigation Department of the Ministry of Public Security of China (ECID) has been established, thereby enabling it efficiently to receive referrals of the clues of suspected cases and to make referrals to the PSOs.

The courts have also placed the prosecution of insider dealing high on their agenda. Although article 180 of the CL 1997 was not used until 2003, six years after insider dealing was criminalised in 1997, the number of criminal cases suggests a subsequent increase. It has, collaborating with the SPP, the MPS, and the Ministry of Justice, promulgated a number of legal guidelines on insider dealing. Among these rules, the most important is the IID 2012, which redefines the scope of ‘insider’ and ‘inside information’. It also clarifies the standards for identifying the seriousness of the circumstances of insider dealing offences. The IID 2012 has been generally welcomed.

While recognising the efforts of the CSRC and the courts in attempting to curb insider dealing, the overwhelming view, particularly of investors, commentators, and legal professionals, however, is that insider dealing regulations have not been adequately enforced. One aspect of the insider dealing debate in China has been the constant reference to the scarcity of cases

combined with lenient sentences. The difficulties of detection and identification are great, and the CSRC and the courts have not really addressed this issue. The work undertaken by Guo in interviewing people from the financial, regulatory, judicial, and legal sectors concludes that, although the precise extent cannot be quantified, insider dealing does occur with great frequency throughout the financial industry and business world. It is hard to find anyone who is willing to give credit to the enforcement, both public and private, of insider dealing regulations from individual investors (Guo, 2012, p. 442). Many hold a much more negative approach, such as one lawyer, who said:

The laws (of insider dealing and other securities irregularities) are only a ‘face job’ without any substantial deterrence. Neither do they have any enforceability. The CSRC has vowed to protect individual investors in China, but investors’ confidence cannot be won unless they witness a satisfactory and convincing enforcement record. It is true that the CSRC sometimes does enforce the laws, but its hands are usually tied because of too many concerns. There is a general belief in the industry that insider dealing regulations are fearless, as they are not enforceable. There are not too many administrative cases, a very small number of criminal cases, and even fewer civil cases, and no attempt is made by either the CSRC or the courts to protect investors by assisting them to recover their losses resulting from insider dealing. It is impossible to win a civil litigation in China. A prosecution would be successful only if the offender were deemed ‘evil’ by the government.<sup>iii</sup>

The general disappointment over the CSRC enforcement of the insider dealing law reflects poorly on regulation and may be interpreted as a worrying public distrust of the government. It is clear that the regulators of the securities markets and the judiciary face real problems in the enforcement of insider dealing regulations, especially in terms of finding and retaining experienced staffing and adequate funding.<sup>iv</sup>

### **Criticisms of the enforcement of criminal insider dealing cases**

The disappointment is worsened by the wide criticism on the over reliance on the CSRC in the criminal investigation and criminal enforcement of insider dealing cases.

The existing investigative power of the CSRC is backed by the Public Security Organs of China (PSOs). The investigators of the CSRC Enforcement Bureau have the power to enter relevant workplaces to conduct inspections and investigations, and to exercise the power to copy documents,

conduct an enquiry, freeze properties, seal up properties, and restrict transactions, etc. These powers are backed by the PSOs. According to article 2 of the Notice for Strengthening Enforcement Cooperation for Combating Securities and Futures Related Crime in 2006, those who hinder CSRC investigators from entering relevant workplaces to conduct inspections and investigation, and to exercise their power to copy documents, conduct an enquiry, freeze properties, seal up properties, and restrict transactions, etc., or those who refuse to be questioned by the CSRC investigators, are suspected of violating the administration of public security and will be punished. After the investigation, the CSRC will collect relevant evidence in a timely manner and issue a 'Transfer Letter on Obstructing CSRC Law Enforcement' and pass it to the PSOs for them to investigate and punish in accordance with law. According to article 4 of the 2006 Notice, anyone concealing, transferring, selling, or damaging the properties seized, sealed up, or frozen by the CSRC, or forging, concealing, or destroying evidence or providing false testimony or misrepresenting the case, thus affecting the CSRC's lawful handling of cases, will be subject to administrative penalties or criminal penalties by the public securities bureaus where appropriate. In accordance with article 5 of the Several Rules on the PSOs' Handling of Economic Crime Cases in 2005,<sup>v</sup> the CSRC shall promptly report suspicious transactions to the PSOs and ask for cooperation in conducting an investigation during everyday supervision and the investigation of securities and futures offences. The PSOs then decide whether to launch an investigation and file a criminal case according to the investigation. When transferring insider dealing cases to the PSOs, the CSRC has to enclose investigation reports of the suspected crime and lists of the evidence and findings according to the Notice on Enforcement Cooperation in Combating Crime in Security and Future Markets by the CSRC in 2006. Article 29 and article 30 of the Several Rules 2005 state that the PSOs have the power to summon, detain, and arrest suspects and to search, detain, and freeze properties when investigating economic crime cases. The PSOs, therefore, are equipped with a wider range of more extensive powers in economic crime investigation compared with the CSRC.

The first major concerns regarding the CSRC conducting criminal investigations is that the investigative power of the CSRC Enforcement Bureau is limited compared with some powerful counterparts, such as the Division of Enforcement of the US Securities Exchange Commission (SEC). The Enforcement Bureau of the CSRC does not have the power to summon the parties concerned. This has been one of the major obstacles for the CSRC to extract evidence from uncooperative parties concerned, as much staff time was spent on travelling between different venues to collect evidence and witness statements whilst the number of staff of the CSRC Enforcement Bureau was insufficient because of the growing demand for investigation (Xiao, 2013). Further, if any of the concerned parties gives a false statement, the CSRC Enforcement

Bureau does not have power to impose any sanction for perjury. This lack of legal deterrence entails zero cost for forgery. Meanwhile, the CSRC Enforcement Bureau does not have the power to tap parties concerned with a wiretap like the relevant department of the SEC. This means another loss of an opportunity for accurate intelligence. The CSRC Enforcement Bureau is therefore deemed to have insufficient investigative power to extract truthful evidence and financial intelligence for insider dealing criminal cases.

The second concern regarding the CSRC's ability to conduct criminal investigations is based on the geographically unbalanced allocation of the investigative resources of the CSRC. Currently, criminal investigations of the securities and futures-related cases are mainly conducted by the headquarters of the CSRC Enforcement Bureau and two special agent offices in Shanghai and Shenzhen (where the two Chinese stock exchanges are located), and these are supplemented by regional CSRC Enforcement Bureau offices within CSRC regional branches. Among all of the regional CSRC Enforcement Bureau offices, the offices in Shanghai, Shenzhen, Beijing, and Guangdong are the ones with most resources and equipped with sufficient staff. However, the CSRC Enforcement Bureau offices in the economically deprived western regions are very poorly equipped in terms of both funding and human resources. Consequently, the investigative resources have been overly concentrated in the economically more developed southeast region of China, which results in an overlap and subsequent waste of resources. The uneven allocation of investigation resources creates further difficulties for the CSRC Enforcement Bureau Headquarter when it has to join forces with the CSRC regional branches to investigate cross-region offences.

In 2008, the Ministry of Public Security formed a special task force, the Crime Investigation Bureau of the Ministry of Public Security (Securities Crime Investigation Bureau hereafter) in Beijing, Shanghai, Shenzhen, Dalian, Wuhan, and Chengdu, to investigate securities and futures related-criminal cases. Consequently, a Notice on Several Issues Concerning the Application of Criminal Procedure of the Crime Investigation Bureau of the Ministry of Public Security's Investigation of Securities and Futures Related Criminal Cases 2008 was produced.<sup>vi</sup> According to article 3 of the 2008 Notice on Several Issues, the Crime Investigation Bureau exercises criminal investigation power delegated by the Criminal Procedure Law on insider trading and divulging inside information cases, and has the power to decide to summon, summon by force, impose bail, carry out residential surveillance, or carry out detention in accordance with the laws and regulations. In practice, however, the Crime Investigation Bureau of the Ministry of Public Security has not been carrying out the investigation and detection role of insider dealing criminal cases. Rather, the

Crime Investigation Bureau's role is more to verify the evidence gathered by the CSRC Enforcement Bureau.

During the investigation, prosecution, and court trial, the PSOs, the PP, and the courts have given up a large portion of independent judgement on the identification of key facts of insider dealing criminal cases, such as the identification of the sensitive period of inside information and the identification of insiders. In particular, the courts, instead of being provided with solid evidence from both parties to draw their own conclusion, largely rely on the official confirmation letter issued by CSRC to decide on key facts, such as the identification of 'insider information' and the 'sensitivity period' of the stock price. The sensitivity period of the inside information is one of the most significant elements in deciding whether there has been a breach of article 180 of the Criminal Law and in calculating the amount of monetary fine payable and the length of prison sentences to be served by the offender should there be a successful conviction.

The heavy reliance on the insider dealing confirmation letters of the CSRC as absolute evidence in the courts has been demonstrated in recent cases. Among the 63 insider dealing criminal case judgements dating from 10 March 2003 to 8 November 2019, 25 out of the 63 judgements recorded that the investigation of the public securities bureaus, the prosecution of the protectorates, and the judgements of the courts were made based on the official confirmation letters and/or the official transfer letters issued by CSRC. <sup>vii</sup>All but two defendants in those 25 cases questioned the legal effect of the confirmation letters and the official transfer letters as evidence; both appeals were, however, dismissed by the courts. In the criminal judgement of Zhongyi Wang and Yihong Wang Insider Trading and Divulging Inside Information, <sup>viii</sup> defendant Zhongyi Wang disputed the legitimacy of using the confirmation letter of the CSRC as evidence. The court dismissed the appeal based on article 4 of Opinions on Handling Securities and Futures-Related Criminal Cases by the People's Supreme Court, the Supreme People's Procuratorate, the Ministry of Public Security, and the CSRC 2011 (Opinion 2011) <sup>ix</sup> which states that PSOs, PPs, and the courts may, in the course of handling suspected securities and futures-related criminal cases, ask the CSRC to appoint professional officials to assist in checking and copying the relevant materials. The CSRC may, in accordance with their needs, provide legal opinions for the PSOs, procuratorates, and the courts. The court concluded that the official confirmation letter was essentially the CSRC providing a professional opinion on the securities and futures criminal cases in accordance with Opinion 2011. It can therefore be relied on as evidence. However, article 4 of the Opinion only says the court may ask the CSRC to 'check and copy relevant materials' and 'issue legal opinions', which does not necessarily mean that the court must adopt those 'legal opinions' as absolute evidence. In reality,

the courts use those ‘legal opinions’ directly as evidence and do not dispute them. In the criminal judgement of Bribery, Insider trading and Divulging Inside Information of Shangdong Zhicheng Group Companies and Xu, the court dismissed the defendants’ appeal by simply giving the reason that the CSRC issued a confirmation letter responding to the request of the Crime Investigation Bureau in accordance with the relevant laws and regulations. Nevertheless, the legality of the confirmation letter does not qualify it as evidence in court. Similar reasoning was given in the Baochun Liu and Qiaoling Chen insider trading case. <sup>x</sup>The tendency of the absolute reliance on the insider dealing confirmation letters of the CSRC as evidence in courts, in practical terms, results in the suspects and the defendants being less able to cross-examine the most significant aspects of their cases to defend their legitimate rights.

Further, the over reliance on the confirmation letter of the CSRC as evidence does not conform with the Criminal Procedure Law of the PRC. More specifically, using the confirmation letter of the CSRC as evidence conflicts with the definition of ‘evidence’ in the Criminal Procedure Law of the PRC. Article 54 of the Criminal Procedure Law of the PRC provides that a people's court, a people's procuratorate, and a PSO shall have the authority to gather or require the submission of evidence from the relevant entities and individuals. The relevant entities and individuals shall provide true evidence. Physical evidence, documentary evidence, audio-visual recordings, electronic data, and other evidence gathered by an administrative authority in the process of law enforcement and case investigation may be used as evidence in criminal procedures. The courts may consequently use evidence gathered by an administrative authority in making decisions on a criminal case. Article 48 of the Criminal Procedure Law of the PRC defines what is admissible as evidence under the Criminal Procedure Law. The article qualifies only six categories of evidence that may be accepted in the courts. These are (1) physical evidence; (2) documentary evidence; (3) witness statement; (4) victim statement; (5) confession and defence of a criminal suspect or defendant; (6) expert opinion; (7) transcripts of crime scene investigation, examination, identification, and investigative reenactment; and (8) audio-visual recordings and electronic data, and all eight categories of evidence must be verified before they can be used as the basis for deciding cases. The official letter of a government agency does not fall into any of those categories, and no verification process is put in place to verify how conclusions are reached in those CSRC official conformation letters.

## **Recommendation on improvement**

*Recommendation one: higher maximum term of imprisonment and fines*

Unlike the maximum terms of imprisonment for insider dealing in the US and the UK—seven years and twenty years, respectively—China stipulates a lower term of five to ten years. While we accept that, in reality, it is unlikely that the courts will use the maximum penalty, the legislature in setting a level has a denunciatory impact emphasising the seriousness of the offence (Rider, 1995). The maximum term of imprisonment for other crimes against property or public benefits is generally fifteen years in China. In light of this, the authors suggest that it would be appropriate to impose a term of imprisonment of five years, with a maximum of fifteen.

In terms of a monetary fine, the authors suggest bringing the monetary fine under article 180 of the CL 1997 in line with the SL 2020 including increasing the monetary fine from five times the illegal gain to ten times the illegal gain and matching up the amount of the monetary fine to SL 2020 where the illegal gain could not be identified in a criminal normal insider dealing case, and to replace the fixed amount by an unlimited amount depending on the discretion of the judge in serious criminal cases.

In article 180 of the CL 1997, there was merely a mention of an optional monetary fine of between one time to five times the illegal gain of normal insider dealing and a compulsory monetary fine of between one time to five times the illegal gain of severe insider dealing. There was no consideration of circumstances where illegal gains could not be identified. Meanwhile, article 191 of the SL 2020 dramatically increased the cost for breaching insider dealing regulations by imposing a considerably greater monetary fine on insider dealing offenders. Where the amount of the illegal gain can be identified and calculated, the maximum administrative monetary fine that may be imposed on the offender is increased from five times the illegal gain to ten times the illegal gain. Where the illegal gain cannot be found or a sum of illegal gain lower than 500,000 Yuan is found, a fine of more than 500,000 Yuan and less than five million Yuan will be imposed if the offender is a natural person, and a fine of more than 500,000 Yuan and less than two million Yuan will be imposed if the offender is a corporate person. Meanwhile, the minimum amount of the administrative monetary fine has been raised from 30,000 Yuan to 500,000 Yuan, and the maximum amount of the administrative monetary fine has been raised from 600,000 Yuan to five million Yuan; both indicate a more than ten-fold increase.

On the one hand, illegal earnings should not be the only consideration here; avoided loss is also an objective of insider dealing. On the other hand, imposing a fixed fine is inflexible, and the current amount of the fine is insufficient to deter insiders from pursuing illegal benefits.



Accordingly, this article suggests that it would be sensible to replace the fixed amount by the unlimited amount in serious criminal insider dealing cases, relying on the discretion of the judge. Meanwhile, the term ‘illegal earnings’ could be replaced by ‘illegal benefits’ to include earnings and avoided loss. It must always be remembered that insider dealing is an economic crime motivated primarily by financial gain. It is the disproportionate benefits that may be obtained as a consequence of abusing the opportunity that incentivise the misconduct. Therefore, attempting to deprive the wrongdoer of his or her ill-gotten gains is crucial.

*Recommendation two: handing over the criminal investigation mission to the Crime Investigation Bureau and restrict the legal effect of the CSRC official confirmation letter in court*

The current approach to the public enforcement of insider dealing violations relies heavily on the CSRC. The limited investigative power and the geographically unbalanced allocation of investigative resources of the CSRC make it a much weaker investigator than the Crime Investigation Bureau of the Ministry of Public Security. The authors therefore suggest handing over the criminal investigation mission to the Crime Investigation Bureau of the Ministry of Public Security from the CSRC and leaving merely a technical support for the CSRC.

Based on the illegality of the court’s absolute reliance on the CSRC official confirmation letter as evidence for the key facts of insider dealing criminal cases under the Criminal Procedure Law of the PRC, and the loss of the dependents’ legal right to question or challenge the evidence because of it, the authors call for a more restricted use of the CSRC official confirmation letter as evidence in court.

### **Concluding Observations**

The enactment of the Securities Law 2020 prompts the necessity and urgency to review the criminal regulatory framework of insider dealing in China in addition to its administrative and civil regulatory framework for a holistic and streamlined approach in coping with insider dealing.

It is generally believed that the number of prosecuted insider dealing cases is far fewer than those that actually occur. The pattern of monetary punishments of the criminal insider dealing cases indicates that small fines have been imposed, most of which have only been equal to the illegal gains. To bring the law in line with the modern change of financial misconducts and the

relevant new rules in the Securities Law 2020, a higher maximum term of imprisonment and much larger fines are recommended.

An over-reliance on the CSRC in relation to criminal investigation, prosecution, and court trials is identified and criticised due to the limited investigative power and the geographically unbalanced allocation of investigative resources of the CSRC and the illegality of the court's absolute reliance on the CSRC official confirmation letter as evidence under the Criminal Procedural Law. A more decentralised role of the CSRC in the public enforcement of criminal insider dealing cases is suggested. The proactive utility of the criminal investigation expertise of the Crime Investigation Bureau of the Ministry of Public Security and exercising the courts' discretion in criminal insider dealing cases are encouraged.

## Notes

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<sup>i</sup> A Complete Collection of Laws, Rules and Regulations 137-173.

<sup>ii</sup> In an Opinions on Combating and Preventing Insider Dealing 2010, it required the collaboration of multiple government agencies, including the CSRC, the Ministry of Public Security (MPS), the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).

<sup>iii</sup> Interview with Yixin Song, Senior Partner of Shanghai Xinwang Wenda Law Firm, (Telephone Interview, 15 March 2012)

<sup>iv</sup> Interview with Zixue Zhang, Commissioner the Administrative Sanction Committee of the CSRC, (Beijing, 10 2012)

<sup>v</sup> Several Rules on the PSOs' Handling of Economic Crime Cases 2005

<sup>vi</sup> Notice on Several Issues Concerning the Application of Criminal Procedure on the Crime Investigation Bureau of the Ministry of Public Security's Investigation of the Securities and Futures Related Criminal Cases 2008

<sup>vii</sup> See <[www.lawsdata.com](http://www.lawsdata.com)> accessed 8 April 2020.

<sup>viii</sup> *Wang Zhongyi & Wang Yihong* [2016] Quanzhou City Intermediate People's Court, Fujian Province, Min 05 Xingchu, No 92

<sup>ix</sup> Opinions on Handling Securities and Futures Related Criminal Cases by the People's Supreme Court, the Supreme people's procuratorate, the Ministry of Public Security and the CSRC 2011

<sup>x</sup> *Liu Baochun & Chen Qiaoling* [2013] Nantong City Intermediate People's Court, Jiangsu Province, Su Fa, No 201112

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