

THE MISAPPROPRIATION THEORY UNDER THE CHINESE SECURITIES LAW - A COMPARATIVE STUDY WITH ITS U.S. COUNTERPART

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I. Introduction

The first stock exchange in China, the Shanghai Stock Exchange, opened in December 1990. Since then, China's securities market has been on a journey of unprecedented development. However, the fledgling securities market is troubled by rampant securities fraud, evidenced by Chinese officials' open admission that investment in China's securities market is very risky because of fraud and corruption. After a tortuous six-year drafting process, on December 29, 1998, the Chinese parliament passed the country's first national Securities Law ("the Chinese Securities Law"), hoping to regulate the overwhelming fraud and corruption in China's

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securities market.¹ The Chinese Securities Law devoted one entire section of the Chapter "Securities Trade," entitled "Prohibited Trading Activities," to regulate securities fraud.²

Because the Chinese Securities Law is modeled in many ways on U.S. securities laws, it seems its antifraud scheme also supports a form of misappropriation theory³, whose validity was only recently affirmed by the U.S. Supreme Court.⁴ This Note will focus on the misappropriation theory supported by the Chinese Securities Law and make a comparison with the misappropriation theory under U.S. securities laws. After outlining the misappropriation theory under U.S. securities laws and the antifraud provisions of the Chinese Securities Law, this Note will demonstrate that the Chinese Securities Law supports a form of the misappropriation theory with a wider scope than its U.S. counterpart. This Note will further argue that (i) the wider scope of the misappropriation theory under the Chinese Securities Law will eliminate a loophole in the U.S. misappropriation theory so that it will better maintain the integrity of the securities market, and (ii) the greater breadth of the Chinese misappropriation theory will probably cover certain proper securities trading as well. Finally, this Note will *recommend* that the Chinese Securities Law adopt the "use" test of the U.S. misappropriation theory to avoid interference with lawful securities trading.

II. The Misappropriation Theory under U.S. Securities Laws

The U.S. Congress enacted the 1934 Exchange Act as an antifraud scheme with a major purpose to maintain the integrity of the securities markets by regulating exchanges and broker-dealers.⁵ Section 10(b)⁶ of the 1934 Exchange Act, together with Rule 10b-5⁷ promulgated by the United

¹ The main goal of the Chinese Securities Law is to "standardize the issuing and trading of securities, to protect the lawful rights and interests of investors, to safeguard the social and economic order and the public interest and to promote the development of the socialist market economy." PRC, SECURITIES LAW 3700/98.12.29 [P.R.C. SEC. L.] art. 1. (CHINA LAW & PRACTICE, Feb. 1999, at 25) (P.R.C.).

² See "Prohibited Trading Acts," P.R.C. SEC. L. art. 67-77 (CHINA LAW & PRACTICE, Feb. 1999, at 38-41).

³ An insider trading theory for Rule 10b-5 liability under the Exchange Act and SEC rules. See *O'Hagan v. United States*, 521 U.S. 642, 652 (1997).

⁴ See *id.* at 653.

⁵ Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78(k) (1994).

⁶ Securities Exchange Act of 1934 § 10(b) (prohibiting the "use or employ[ment], in connection with the purchase or sale of any security, . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.").

⁷ See 17 C.F.R. § 240.10b-5 (1996) (Rule 10b-5 states in pertinent part that it shall be illegal for any person "to employ any device, scheme, or artifice to defraud . . . in connection with

States Securities and Exchange Commission ("SEC") thereunder, represents the principal federal law of insider trading. A chargeable conduct under Section 10(b) must involve (1) a "deceptive device or contrivance;" and (2) the use of such device "in connection with" the purchase or sale of securities.⁸

Relying on the common law's definition of fraud which permits nondisclosure in the absence of a duty to disclose, the U.S. Supreme Court emphasized the need for a breach of fiduciary duty to constitute 10b-5 liability.⁹ The Court held that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."¹⁰ Currently, insider trading liability requires a breach of fiduciary duty to the shareholders of the issuer or to the source of the information.¹¹ These two grounds for liability represent, respectively, the classical insider trading theory and the misappropriation theory.

Under the classical insider trading theory, a corporate insider violates Section 10(b) and Rule 10b-5 if he trades in the security of his corporation on the basis of material nonpublic information. In such a case, the insider breaches his fiduciary duty to the shareholders of the corporation that arises from the relationship of trust and confidence between the shareholder and the insider.¹² While "corporate insiders" traditionally included directors, officers and other employees of a corporation,¹³ the Supreme Court's decision in *Dirks v. SEC*¹⁴ expanded insider trading liability to include "temporary insiders," that is, those who perform services for a public company where the relationship entails receipt of inside information that the client expects to be kept confidential.¹⁵

Under the misappropriation theory, one who misappropriates

the purchase or sale of a security").

⁸ See *O'Hagan*, 521 U.S. at 653.

⁹ See *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

¹⁰ See *id.*

¹¹ See *O'Hagan*, 521 U.S. at 653.

¹² In doing so, the insider has employed a "deceptive device." See *id.*

¹³ See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)(asserting that "an affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders").

¹⁴ 463 U.S. 646 (1983).

¹⁵ See *Dirks*, 463 U.S. at 655, n.14. (stating that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders").

confidential information for securities trading purposes in breach of a fiduciary duty owed to the source of the information also violates Section 10(b) and Rule 10b-5.¹⁶ The misappropriation theory is usually referred to as the "fraud on the source" theory¹⁷ because the victim of the breach, the source of the information, is a person separate from the holders of the securities of the corporation with whom the insider trades.

Reaffirming the breach of fiduciary duty as a necessary element for liability under Rule 10b-5, the Supreme Court in *O'Hagan*¹⁸ upheld the misappropriation theory¹⁹ because the agent *breached* the fiduciary duty owed to the source of information; *that is, the duty* not to use the material, nonpublic information for secret profit when he traded securities based on that information.²⁰ The *O'Hagan* court treated the classical theory and the misappropriation theory as "complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities."²¹

The difference between the two theories can be illustrated by the following simple example of a lawyer's representation of the bidder in an imminent merger of two companies. If the lawyer trades the securities of the bidder based on material nonpublic information related to the merger, classical insider trading liability will be triggered because the lawyer is an insider of the bidder. However, if the lawyer trades the securities of the target based on material nonpublic information related to the merger, he will be subject to insider trading liabilities under the misappropriation theory because he *breached the fiduciary duty owed to the source* of the information, the bidder, not the duty owed to the target company.

III. The Misappropriation Theory under the Chinese Securities Law

The anti-fraud scheme under the Chinese Securities Law resembles

¹⁶ See *O'Hagan*, 521 U.S. at 653.

¹⁷ See *id* at 682 (Thomas, J., concurring in the judgment in part and dissenting in part).

¹⁸ See *id*

¹⁹ The federal courts were divided over the legality of the misappropriation theory until it was finally upheld by the U.S. Supreme Court in *United States v. O'Hagan*. Compare *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990)(asserting that "misappropriation and use of confidential information in breach of a fiduciary or similar duty amounts to fraud within the meaning of the statute"), and *SEC v. Singer*, 786 F. Supp. 1158, 1163 (S.D.N.Y. 1992)(stating that "misappropriation, has been adopted in several circuits"), with *United States v. Bryan*, 58 F.3d 933, 949 (4th Cir. 1995)(finding that the "misappropriation theory cannot be defended"), and *United States v. ReBrook*, 58 F.3d 961, 965 (4th Cir. 1995)(reversing conviction and sentence for securities fraud and refusing to adopt the misappropriation theory).

²⁰ See *O'Hagan*, 521 U.S. at 652.

²¹ *Id*.

that of the U.S. regime. Article 70 of the Chinese Securities Law prohibits (1) informed persons with the knowledge of inside information (corporate insiders) from trading the securities of the corporation;²² (2) any other person who has illegally obtained inside information (misappropriators) from trading the securities of the corporation on which he has inside information; and (3) insiders and misappropriators from divulging such information or counseling another person to trade such securities.²³

In prohibiting anyone who has acquired inside information through illegal measures from trading it for secret profit, Item (2) of Article 70 essentially supports the misappropriation theory because it focuses on the way in which the trader acquires the information, rather than the relationship between the misappropriator and the traded corporation. Further, because it does not require a fiduciary relationship between the misappropriator and the source of the information, its scope is potentially wider than the *O'Hagan* misappropriation theory.

IV. The Wider Scope of the Misappropriation Theory under the Chinese Securities Law is a Desirable One

The *O'Hagan* misappropriation theory is narrower than the theory suggested by Chief Justice Burger in *Chiarella*, which was the seed of the misappropriation theory.²⁴ Unlike the *O'Hagan* Court, which put emphasis on the breach of fiduciary duty to the source of information, the Chief Justice found that the language of Section 10(b) and Rule 10b-5 supported a reading that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.²⁵ The difference between the two theories is significant because the *O'Hagan* misappropriation theory allows a trader to escape liability either if he does not have a fiduciary duty to the source of the information or if he discloses

²² Item (1) essentially supports the same classic insider trading theory as U.S. securities laws since the concept of "corporate insider", as defined in Article 68 of the Chinese Securities Law, is also wide enough to include "temporary insiders." See P.R.C. SEC. L. art. 68 (CHINA LAW & PRACTICE, Feb. 1999, at 38-39).

²³ Item (3) essentially supports "tippee" and "tipper" liability, which was established in *Dirks*. See *Dirks*, 463 U.S. at 662-664; P.R.C. Sec. L. art. 70 (CHINA LAW & PRACTICE, Feb. 1999, at 39-40).

²⁴ See *Chiarella*, 445 U.S. at 241-42 (Burger, C.J., dissenting).

²⁵ See *id.*, at 239-40 (Burger, C.J., dissenting).

his trading activities to the source.²⁶

The liability framework in Article 70 of the Chinese Securities Law resembles Chief Justice Burger's theory, because anyone who has gained information through illegal measures is absolutely prohibited from trading in the securities of that corporation.²⁷ This theory is more logical than the *O'Hagan* theory because it depends on the way in which the misappropriator receives the information, not the person from whom he receives such information, that determines the duty to disclose or abstain from trading. As one commentator has written: "[T]he way in which the buyer acquires information which he conceals from the vendor should be a material circumstance."²⁸

By eliminating the fiduciary duty element,²⁹ the Chinese misappropriation theory will fix a loophole in the *O'Hagan* misappropriation theory. First, problems abound in determining what constitutes a fiduciary relationship. In *United States v. Chestman*,³⁰ the tipper learned of certain material nonpublic information from his wife, who did not demand confidentiality, and it formed the basis for trading before the information became public.³¹ The Second Circuit, sitting *en banc*, held that the marital relationship was not itself a sufficient basis upon which the misappropriation theory would operate.³² By contrast, in *United States v. Willis*³³, where a psychiatrist traded on information that his patient shared with him during one of their sessions, the court found that the psychiatrist breached the physician's duty of confidentiality when he misappropriated non-public business information confided to him by his patient for her psychiatric diagnosis and treatment.³⁴ Whether the misappropriator and the source of information have a fiduciary relationship is not an easy question to answer.

²⁶ See *O'Hagan*, 521 U.S. at 652-55.

²⁷ A duty to disclose is essential to common law fraud. If there is no duty to disclose, nondisclosure will not result in fraud. Under the classical theory and the *O'Hagan* misappropriation theory, a fiduciary relationship is required because that is from where the duty to disclose arises. However, under the misappropriation theory suggested by Chief Justice Burger, the misappropriator has an absolute duty to disclose so that a fiduciary relationship is not an issue here. See Chiarella, 445 U.S. at 240 (Burger, C.J., dissenting).

²⁸ W. Page Keeton, *Fraud, Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25 (1936).

²⁹ Or, it can be argued that the fiduciary duty element is automatically satisfied since, according to Chief Justice Burger, the misappropriator owes to marketplace traders an absolute duty to disclose-or-abstain once he misappropriated nonpublic material information. See Chiarella, 445 U.S. at 240 (Burger, C.J., dissenting).

³⁰ 704 F. Supp. 451 (S.D.N.Y.1989), *rev'd*, 903 F.2d 75 (2d Cir. 1990), *reh'g en banc*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S.Ct. 1759 (1992).

³¹ See *United States v. Chestman*, 903 F.2d 75, 77-78 (1990).

³² See *United States v. Chestman*, 947 F.2d 551, 568 (1992)(*en banc*).

³³ 737 F. Supp. 269, 272 (S.D.N.Y. 1990), *mot. denied*, 778 F. Supp. 205 (S.D.N.Y. 1991).

³⁴ See *Willis*, 737 F.Supp. at 274.

Second, from the perspective of market participants, the deceptiveness of trading on misappropriated information will not change regardless of whether the misappropriator has a fiduciary relationship with the source of information or whether the misappropriator discloses his trading activities to the source before he trades. The misappropriator has an illegally obtained advantage that would have existed even if he had not owed a fiduciary duty to the source of information or *even* if he had disclosed his activities to the source. For the purposes of a marketplace securities exchange, the existence of a fiduciary duty between the misappropriator and the source of the information is irrelevant. Likewise, the disclosure of the misappropriator to the source of information does not eliminate the fraudulent element of the securities transaction between the marketplace traders and the misappropriator.

Finally, public policy concerns support the broader scope of misappropriation theory under Chinese Securities Law. In *Chiarella*, Chief Justice Burger, based on a public policy rationale, interpreted section 10(b) extraordinarily broadly to "reach any person engaged in any fraudulent scheme."³⁵ As the *O'Hagan* Court noted, if the market is thought to be systematically populated with transactors trading on the basis of misappropriated information, some investors will refrain from dealing altogether, and others will incur costs to overcome their unavoidable informational disadvantages.³⁶

For the development of the fledgling Chinese securities market, China's Securities Law, just as the history of the U.S. statutes and rules suggest, should prohibit "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function."³⁷ Since the misappropriators' securities trading on the basis of misappropriated nonpublic information serves no useful function, resulting in the unjust enrichment at the expense of others, an absolute duty should be imposed on the misappropriators prohibiting them from trading on any nonpublic material information.

In short, the misappropriation theory under Chinese Securities Law, similar to that suggested by Chief Justice Burger in *Chiarella*, will better maintain the integrity of the security market than the current

³⁵ See *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting).

³⁶ See *O' Hagan*, 521 U.S. at 659.

³⁷ *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting) (quoting S. Rep.No. 792, 73d Cong., 2d Sess., 6 (1934)).

misappropriation theory under U.S. Security Law in that: (1) the theory avoids the troublesome fiduciary duty question which will lead to more consistent outcomes; (2) the theory follows naturally from the equity concern of the securities laws and regulations; and (3) the theory is consistent with public policies.

V. Caveat: Wider is not Always Better

In the U.S., prior to *O'Hagan*, the issue of whether insider trading requires mere possession of material nonpublic information or actual use of such information while trading in securities was not definitively resolved. Although this issue was not before the *O'Hagan* Court because *O'Hagan's* use of material nonpublic information to purchase securities was undisputed, the Court, in dictum, arguably required the affirmative "use" of misappropriated information in a securities transaction, rather than merely trading while "possessing" such information in order to establish inside trading liability.³⁸

By contrast, Article 70 of the Chinese Securities Law prohibits any person who has illegally obtained inside information from buying or selling securities of the company of which he has inside information.³⁹ This approach supports insider trading liability for trading securities based on "possession" of inside information. By adopting the "possession" test, the Chinese Securities Law again supports the misappropriation theory on a wider, although undesirable scope.

The "possession" test may prohibit actions that are not themselves fraudulent per se because insider trading, *although it involves* possession of material nonpublic information, does not invariably and inevitably result in a breach of the duty to disclose or abstain from trading. *In actuality*, the "possession" test may lead to flawed results. For example, where an insider is a party to a binding executory contract to buy and sell securities in his company on a predetermined periodic basis, such a contract to trade would have to be breached under the "possession" test when the insider merely came into possession of material nonpublic information through illegal measures *despite the fact that* the misappropriator's decision to buy or sell his securities was never based on such inside information. As a commentator noted, it strains common usage to say the executives in the

³⁸ See, e.g., *O'Hagan*, 521 U.S. at 656 (stating that "[a] misappropriator who trades on the basis of material nonpublic information... gains his advantageous market position through deception..." (citation omitted) (emphasis added); id. at 656 (stating that "the fiduciary's fraud is consummated...when, without disclosure to the principal, he uses the information to purchase or sell securities.") (emphasis added).

³⁹ P.R.C. SEC. L. art. 70 (CHINA LAW & PRACTICE, Feb. 1999, at 39-40).

hypothetical "take advantage of the inside information when they passively allow a previous decision to be implemented."⁴⁰

A strong argument can be made that a strict "use" test would pose serious difficulties of proof for Chinese securities regulatory authorities, which have limited experience in enforcement of insider trading liabilities. It is true that the motivations for the trader's decision to trade are difficult to prove because they remain solely within the trader's knowledge. However, as a U.S. court observed, the proof difficulty therein is sufficiently alleviated by the inference of use that arises from the fact that an insider traded while in possession of inside information.⁴¹ Executory contract situations, such as the above hypothetical, impose no practical difficulty upon a court to conclude that there is no actual "use" of inside information in such securities transactions.⁴²

VI. Conclusion

With the aim of eliminating market fraud and corruption, the Chinese Securities Law has put considerable emphasis on the prohibition of insider trading. It supports a form of misappropriation theory similar to the misappropriation theory under U.S. securities laws.

While the misappropriation theory under U.S. securities laws bases securities fraud liability on a breach of fiduciary duty,⁴³ the misappropriation theory under the Chinese Securities Law places emphasis on the illegal measures employed to gain the inside information *resulting* in a misappropriation theory with broader scope. By eliminating the fiduciary duty element, the Chinese misappropriation theory avoids the inconsistencies arising from the implementation of the U.S. misappropriation theory and better maintains the integrity of the security market.

However, the Chinese misappropriation theory prohibits trading with possession of inside information. Because such a theory does not require the insider's actual use of the inside information, the over-broad insider trading liabilities may result in unnecessary interference with proper securities trading such as a preexisting plan to buy or sell. Therefore, the

⁴⁰ Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 Bus. Law. 1235, 1274 (1997).

⁴¹ See SEC v. Adler, 137 F.3d 1325, 1337 (1998).

⁴² See *id.*

⁴³ See O'Hagan, 521 U.S. at 656.

Chinese misappropriation theory should adopt the “use” test for insider trading liability.