

INSIDER TRADING IN CHINA: COMPARED WITH CASES IN THE UNITED STATES

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TABLE OF CONTENTS

I.	INTRODUCTION	3
II.	RECENT REGULATORY DEVELOPMENT.....	4
III.	CASES OF INSIDER TRADING IN CHINA.....	6
	A. HUANG Guangyu: Refreshing on the Case Details	6
	B. The Shell of Huang	8
	1. <i>The First Shell</i> :.....	8
	2. <i>The Second Shell</i> :	9
IV.	THE JUDGMENT OF HUANG'S CASE.....	11
	A. The First Instance Judgment	11
	1. <i>Crime of Illegal Business Dealings</i>	11
	2. <i>Crime of Insider Trading and Divulging of Inside Information</i>	12
	3. <i>Crime of Corporate Bribery</i>	12
	B. The Second Instance Judgment	13
	C. The Final Judgment from the Supreme People's Court	13
V.	ISSUES FOR THE INVESTORS IN CHINA.....	13
	A. Method of Litigation.....	16
	B. Standard of Compensation.....	18
	C. Evidence.....	20
	D. Recovery of Damages	21
VI.	CASE ON QINGDAO KINGKING AND GUOYUAN SECURITIES	22
	A. Backgrounds	22
	B. Facts on Qingdao Kingking	23
	C. Facts on Guoyuan Securities	24
	D. Judgments	24
	E. Issues from the Cases	25
	F. Issue on Shell Listing	26

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1. <i>What is Shell-borrowing Listing?</i>	26
G. Problems Arise from Shell Listing	30
H. Remedies and Regulations for Shell Listing:.....	32
1. <i>Remedies</i>	32
2. <i>Regulations</i>	34
VII. INSIDER TRADING IN THE U.S.A.	36
A. Illegal	36
1. <i>Definition of "insider"</i>	36
2. <i>Misappropriation theory</i>	37
3. <i>Proof of responsibility</i>	38
B. The Insider Trading Law of the U.S.A.	38
1. <i>Common law</i>	38
VIII. THE INSIDER TRADING CASES OF RAJARATNAM, GOFFER AND GUPTA	40
A. Facts	40
B. Rajaratnam: October 16, 2009	41
1. <i>Intel</i>	42
2. <i>Trading Ring Scheme</i> :.....	42
3. <i>The Case of McKinsey</i>	43
4. <i>Google</i>	44
5. <i>The Investigation</i>	44
C. Goffer – November 6, 2009	45
D. Gupta — March 2011	46
E. Implications From These Cases	49
1. <i>Inside information and aggressive research</i>	49
2. <i>Employees and price sensitive information</i>	50
3. <i>Issues for the hedge fund on wiretaps</i>	51
4. <i>Circumstantial evidence adopted for conviction</i>	52
5. <i>Penalty should be triple to the gain</i>	53
6. <i>Hedge fund lawsuit risk rises as insurance companies are quoting coverage</i>	54
IX. CONCLUSION.....	54
A. Compare China with the United States	55
1. <i>U.S. Perspective</i>	56
2. <i>China Perspective</i>	56
GLOSSARY	57
BIBLIOGRAPHY	62

I. INTRODUCTION

As discussed in my previous work in *An Insight into Insider Trading in Greater China*,¹ China should be considered a late starter in terms of its insider trading regulatory framework in the Greater China region (compared with Hong Kong and Taiwan). As the Chinese equity market becomes one of the major stock markets in the Asia Pacific region, Chinese legal authorities have started to become aware of the importance of an insider trading regulatory framework in order to facilitate its equity market into a healthy investment environment for investors around the world.

In recognizing its importance, Chinese legal authority not only introduced Security Law in 2005, which provided a mechanism that made it possible for people to bring civil action for losses due to insider trading, but the Supreme Court of China also prescribed "Standing for Legal Action." Within the provisions, it stipulated the dispute of insider trading of securities and manipulation of the securities trading.² Thus, the formal legal foundation of actions taken for insider trading was finally established.

In 2007, China's Securities Regulatory Commission (CSRC) prescribed "the ways to recognize insider trading" on a trial basis. In addition, the Supreme Court also initiated the interpretation and drafting for cases with insider trading and market manipulation.³

According to the new "Securities Law", securities fraud includes three categories: false statements, insider trading, and market manipulation.⁴ Civil actions can be brought against all three of these forms. However, in practice, the court only accepts false statements when every action on securities fraud arises. Insider trading, market manipulation, and other causes of civil compensation cases are "temporarily not being accepted".

In reality, the regulatory framework for insider trading should be a growing mechanism and be amended with the growth of the equity market. As China's equity market grows into an important equity market in the financial world, China's original regulatory framework for insider trading has become inadequate. As a result, the focus of this paper aims to examine the recent insider trading

1. Greg Tzu Jan Yang "An Insight into Insider Trading in Greater China", Maryland Series in Contemporary Asian Studies, No. 1 – 2010 (200), Baltimore: University of Maryland School of Law.

2. OH Bi Lan, "The First Serious Case of Insider Trading", Legal Rules and Democratic Times, October 13, 2008, p. 2.

3. *Ibid.*

4. *Ibid.*

cases in China and tries to provide new perspectives on the Chinese regulatory framework on insider trading in comparison with recent insider trading developments in the United States.

II. RECENT REGULATORY DEVELOPMENT

The growing importance of China's equity market can be seen by its growing number of Initial Public Offerings (IPO) listing in 2010. Even though China's stock market has underperformed compared to the global equity market in 2010, China replaced the U.S. and Brazil to become the most active new IPO listing market. For the first half of 2010, there were a total of 175 IPOs in the Shanghai and Shenzhen stock market, averaging 1.5 IPO per day, receiving RMB\$323.8 billion from the market (USD\$1 = RMB\$6.3577 as of August, 2012).⁵ The growing number of IPOs is due to the Chinese government actively encouraging small to medium sized companies to be listed in the Shenzhen Growth Enterprise Market (GEM) or Shanghai Stock Exchange Small & Medium Enterprises Composites (SSE SME). This in turn has made China's A-shares to be listed the most IPOs in the world.⁶

On the other side of the coin, this growing number of IPO listings has created a new class of wealthy people who gained wealth by listing their company in exchange for capital from the equity market. On average, during the first half of 2010, China created 600 billionaires from IPO listings (which means 1.5 billionaires were created every day).⁷ As a result, the growing number of wealthy people with easy access to market capital created a breeding environment for insider trading activities. This is because the expected IPO stock rally often provided a mechanism for company owners and major shareholders to drastically increase their wealth overnight, therefore increasing the temptation for people to engage in insider trading as it is human nature for rich people to want to become richer.

In recognizing the inadequacy in its insider trading regulatory framework, China's Securities Regulatory Commission (CSRC) in July 29, 2010 decided to launch the *Interim Provisions on the Securities Investment Advisor Business* and *Tentative Provisions for Issu-*

5. Bloomberg Professional System, Bloomberg Finance LP, USA.

6. CHENG Hui Yuen "Active IPO Listing: China is in the Middle of Wealth Creation Process" (2010) Want Daily, Taipei, Taiwan, 8 August, A5.

7. CHENG Hui Yuen "Active IPO Listing: China is in the Middle of Wealth Creation Process" (2010) Want Daily, Taipei, Taiwan, 8 August, A5.

ance of Securities-related Research Reports, to further regulate the investment environment in China.⁸

Within the *Interim Provisions on the Securities Investment Advisor Business*, securities consulting companies should not provide, buy, or sell advice for particular securities on TV, Internet, radio, or any other publications. This is to prevent securities consulting analysts or companies from profiting by advice given to the investor regarding buying or selling particular stocks. Also, within this *Interim Provisions on the Securities Investment Advisor Business*, securities companies who engage in business related to securities or investment consultation is forbidden from engaging in the related business of proprietary trading or asset management.⁹ This prevents securities consulting companies from engaging in opposite trades with their client hence profiting at the loss of their client.

The *Interim Provisions on the Release of Securities Research Reports* is focused on regulating the research reports published by securities companies. When issuing a research report on a particular company, the regulation requires securities companies to announce the amount of the particular shares the company held on hand. Also, on the research report published date and the next trading date, the company proprietary department can not engage in trades in opposite with the recommendation from the research report.¹⁰ The new regulations focus on regulating the publication of research reports from disclosing insider information or allowing their clients to counter trades in the market and profiting from the general investments publics. This regulation is to focus on the independence of the information in research report.

Also, under the growth and development of China's stock, there are a growing number of criminal cases on insider trading over recent years. Up to 2011, there were a total of twenty-two cases on insider trading being closed. There was one case in 2007, one case in 2008, four cases in 2009, five cases in 2010, and eleven cases in 2011. This indicates that insider trading cases have grown at an exponential rate in China over the past few years. As a result, this had led the Supreme People's Court to declare in May 22, 2012 that they decided to introduce a new regulation regarding insider trading *the Interpretation on Several Issues Concerning the Specific*

8. CHEN Shu Lan "China Introduce New Regulations to Prevent Stock Price Manipulation from Stock Analysts" (2010) Want Daily, Taipei, Taiwan, 8 August, A5.

9. *Ibid.* .

10. CHEN Shu Lan "China Introduce New Regulations to Prevent Stock Price Manipulation from Stock Analysts" (2010) Want Daily, Taipei, Taiwan, 8 August, A5.

Application of Law in Handling the Criminal Cases of Insider Trading and Divulgement of Insider Information (hereinafter referred to as “the *Interpretation of Insider Trading*”) on June 1, 2012. There are eleven sections in the *Interpretation of Insider Trading* and this will provide a systematic regulatory framework focus on regulating people with inside information, people receiving inside information illegally, and sensitive time span for inside information, insider trading and the punishment for leaking inside information.¹¹

The introduction of this new regulation should be regarded as a big step for the Chinese regulation framework in recognizing the importance and significance of insider trading. Besides introducing new regulations, the development of a few insider trading cases has also made the Chinese regulatory framework more comprehensive and complete in recent years. In the following sections, we will discuss the development of a few important insider trading cases in China in recent years. Besides the case on HUANG Guangyu, there are a few new important cases that have developed in recent years, the *Qingdao Kingking* and *Guoyuan Securities*. Also, we will closely examine the dealing of shell listing in Chinese companies, as it has become a popular mechanism for quick IPO listing in China, which led to many insider trading activities as a consequence. On the other hand, we will also use the case on Raj Rajaratnam in the United States to compare and contrast with Chinese insider cases to illustrate how insider trading cases are being dealt with in a developed financial market.

III. CASES OF INSIDER TRADING IN CHINA

A. HUANG Guangyu: Refreshing on the Case Details

As the detail of the HUANG Guangyu case was discussed in my precious work, *An Insight into Insider Trading in Greater China*, we will only briefly go over a few important points on this case:

- HUANG Guangyu, chairman of *Gome Electrical Appliances Holdings Ltd.*, (Gome) China’s biggest electrical appliance retailer, was arrested by Beijing Police in late November 2008.
- From 2006, after two years of investigation, the police uncovered evidence of RMB\$70 billion in suspicious capital transactions under Huang’s name, and linked him with financial misdeeds including share price manipulation and money laundering.

11. People’s Daily, <http://www.people.com.cn>, May 22, 2012, China.

- On the same day, officials from the CSRC confirmed that *Beijing Eagle Investment Co Ltd* – a company controlled by Huang – was suspected of manipulating share prices of *Sanlian Commercial Co Ltd* (Sanlian), and *Beijing Centergate Technologies Co Ltd* (Beijing Centergate).¹²
- Huang was investigated for seven financial crimes such as bribing senior officials before *Gome's* listing in Hong Kong, evading taxes by injecting assets into an overseas shell company during *Gome's* merger with Shanghai-based electronics retailer *Yongle*; money laundering concerning Shandong Jintai; manipulating the share prices of *Beijing Centergate Technologies* and *Sanlian Commercial*; and transferring company assets through an underground banking system to his own accounts.¹³
- On August 2008, the Central Commission for Discipline Inspection of the Chinese Communist Party (CCP) launched a stormy investigation into high-level corruption in the foreign investment administration. Several Ministry of Commerce (MOFCOM) officials were forced to step down and HUANG Guangyu's name came up during the investigation. People close to the investigation said that some officials confessed to accepting bribes from Huang before *Gome's* listing in Hong Kong and during its merger with *Yongle*.¹⁴
- What's more, MOFCOM's approval of the merger was surprisingly swift. As it was registered on the British Virgin Islands (BVI), *Gome* was actually a foreign invested company. Therefore, it was very unusual for MOFCOM to have spent only eight days on the reviewing process for a merger involving a foreign invested company. As it was later being discovered, two of the MOFCOM officials under investigation – GUO Jingyi, inspector of the Department of Treaty and Law, and DENG Zhan, former deputy director of the Department of Foreign Investment Administration – played a key role in the approval of the merger.¹⁵

12. YAN Pei, "Dead End for a Tycoon's Creative Financing", <http://www.china.org.cn>, December 3, 2008.

13. Caijing Magazine, <http://www.english.caijing.com.cn>, December 11, 2008.

14. YAN Pei, "Dead End for a Tycoon's Creative Financing", <http://www.china.org.cn>, December 3, 2008.

15. *Ibid.*

B. The Shell of Huang

Besides the above details of Huang's case, HUANG Guangyu was one of the early success stories in first shell listing by successfully bringing his company *Gome Electrical Appliances Holding Ltd* to list in Hong Kong Stock Exchange through shell borrowing listing in 2004. This success in shell listing on IPO made him become the number one richest man in China. Due to this early success, Huang decided to replicate his early success and engaged in shell borrowing listing a few years later. It was the second shell that had brought Huang under investigation and finally his conviction. Even though the details of shell borrowing and making listing will be discussed in a later section, the details on how Huang made his shell will be discussed in detail in this section. This is because the importance of Huang's shell listing process is an important indication that led to his insider trading activities and the consequence that led to small shareholder/investor's suffering from this case.

1. The First Shell:

Huang started his shell listing process by selecting a Hong Kong listed company named *Jinghua Automation Group*. Through issuing equity and acquiring new shares, this company acquired Huang and his brother's company through reverse acquisition. In return, they had gained control of this company, *Jinghua Automation Group*. In July 2002, they changed the name of the company into *China Eagle*. Huang also established another company named *Beijing Eagle* and he had 100% control of this company. He then established *Gome Electrical*, which is 65% controlled by *Beijing Eagle* and he directly owned the remaining 35% interest in *Gome*. Then, he established another company named *Ocean Town* in British Virgin Island and he registered *Gome Holding* in BVI and had 100% control of *Ocean Town*. From April 2004, *Beijing Eagle* transferred its 65% *Gome* shares to *Ocean Town* and the Hong Kong listed *China Eagle* acquired *Ocean Town* hence *China Eagle* had 65% shares of *Gome Electrical*. Finally, Huang changed *China Eagle's* name into *Gome Electrical Appliances* and achieved his goal in listing in Hong Kong through shell listing.¹⁶

Gome Electrical Appliances had achieved its goal of public listing through shell listing all the way from *Jinghua Automation*

16. CHOW Chin Yen "The Protection for Small/Medium Investors under Shell Listing Process" China Academic Journal Electronic Publishing House, <http://www.cnki.net>, March, 2011.

Group to China Eagle and finally *Gome Electrical Appliances*. For HUANG Guangyu, he had gained a huge profit in cash by selling his shares of *Gome* on the stock market. On the other hand, it is the small and individual investors who had suffered during this process. This is because in September 2000, Huang or the controlling shareholders of *Jinghua Automation Group* wanted to affirm its control of the company and diluted the control of other existing shareholders and in return issued 31 million new shares at HKD\$0.4 to raise HKD\$11.9 million (USD\$1 = HKD\$7.7577 as of August, 2012)¹⁷ through private placement. On the other hand, the total number of shares issued has increased to 188 million shares and share prices plummeted from HKD\$1.2 in June to HKD\$0.6 in September. As the new issue of 31 million of new shares only accounted for 19.7% of total shares issued (which is below the 20% threshold), new shares issued do not need to cease trading in the stock market nor receive approval through shareholder meetings. In September 2001, *Jinghua Automation Group* decided to issue new shares again and issued 44.3 million shares at HKD\$0.18 and acquired HKD\$7.97 million. Again, the new shares issued were 19.8% and no shareholder approval was required. This time, the share price plummeted to below HKD\$0.2.¹⁸ As a result, this is the best illustration of the interest of small shareholders/investor being disregarded and manipulated by the company controller and major shareholders. On the other hand, the easy money and quick cash of shell listing had increased Huang's appetite for money and became a prelude for his later downfall.

2. *The Second Shell:*

As *Gome* had made him the richest man in China, Huang decided to push his real estate company into the public capital market as well. As a result, he decided to replicate his shell listing success for his real estate property company. In order to find his shell, he engaged in a relationship with three different companies. One was his brother's company *ST Jintai*. The other two were the companies he controlled: *Sanlian Commercial Co Ltd*, and *Beijing Centergate Technologies Co Ltd*.¹⁹

17. Bloomberg Professional System, Bloomberg Finance LP, USA.

18. *Ibid.*

19. KAO Shiu Guo "Success on Shell and Fail on Shell", China Academic Journal Electronic Publishing House, www.cnki.net, 2009.

In order to let his real estate business be publicly listed, the first shell he approached was *Beijing Centergate Technologies Co Ltd*. *Beijing Centergate* was publicly listed in 1999 at Shenzhen Stock Exchange with capital stock of around 675 million shares. Even though *Beijing Centergate* mostly engaged in research, development, and investment on high tech products, its business performance was definitely less than satisfactory. As a result, this had brought *Beijing Centergate* into the vulture eyes of Huang. From 2006, Huang let his investment company, *Beijing Pengtai Investment, Co Ltd* begin to acquire the shares of *Beijing Centergate* and when he acquired up to 29.58% shares, he became a major shareholder in *Beijing Centergate*. Through the reverse acquisition he had previously done, by May 4, 2008, *Beijing Centergate* announced its acquisition of Huang's *Beijing Pengrun Property Development Holding Company Limited* and hence transformed from a technologies company into a real estate company. Unfortunately, this acquisition was not successful. Three months later, *Beijing Centergate* announced to abort the plan on acquiring *Beijing Pengrun Property Development Holding Company Limited*. Even though Huang continued to look for another shell, he had already engaged in insider trading by manipulating the share price of *Beijing Centergate* during the shell making process. He first spread bad news about *Beijing Centergate* in the stock market on June 27, 2007 in order for him and his affiliated parties to acquire shares of *Beijing Centergate* at low prices. On May 7, 2008, he let *Beijing Centergate* announce the news of company restructuring in order to stimulate a rally in share prices. As a result, he sold around RMB\$300 million of *Beijing Centergate* shares on May 7 and 8.²⁰ This insider trading activity attracted the attention of Chinese regulators and later led to the downfall of Huang.

As the shell making on *Beijing Centergate* was unsuccessful, Huang approached another potential shell, *Sanlian Commercial Co Ltd*. In February 14, 2008 Huang approached *Sanlian* by acquiring 27 million shares of *Sanlian* through his controlled real estate company, *Shandong Long Ji Dao Co Ltd* and gained controlled on *Sanlian* with 19.71% shares. During this process, the news that *Sanlian* would become a shell for Huang had spread in the market. This had made the share price and traded volume of *Sanlian* to change turbulently. For example, the traded volume of *Sanlian* on March 10 was only 34,000 shares. From March 11, the traded volume in-

20. *Ibid.*

creased to 28 million shares and on March 12, to 47 million shares. This huge increase in traded volume attracted CSRC's attention and they began to investigate *Sanlian* on March 28. This later led to the arrest of Huang and the downfall of his money empire.²¹

IV. THE JUDGMENT OF HUANG'S CASE

A. The First Instance Judgment

After years of investigation and prosecution, on May 18, 2010, in the first instance judgment in the HUANG Guangyu's case, Beijing Second Intermediate People's Court issued its judgment: for the crime of illegal business dealings, the court sentenced HUANG Guangyu to a jail term of 8 years and ordered his personal properties valued at RMB\$200 million to be confiscated; for the crime of insider trading, the court sentenced HUANG Guangyu to a jail term of 9 years, and ordered fines of RMB\$600 million; for the crime of corporate bribery, the court sentenced HUANG Guangyu to a jail term of 2 years. Upon a joinder of punishment for the several counts of the crime, the Court decided to enforce a jail term of 14 years, with fines of RMB\$600 million and confiscation of personal property valued at RMB\$200 million.²²

As shown from the court judgment, the court focused on three major crimes Huang had committed:

1. *Crime of Illegal Business Dealings*

During the period from September 2007 to November 2007, Huang had violated relevant state regulations by engaging in illegal foreign exchange trading with RMB settlement in the mainland and Hong Kong Dollar settlements outside the mainland. The violation involves the transfer of RMB\$800 million, either directly or through *Beijing Heng Yi Xiang Business Consulting Company Limited* (Heng Yi Xiang), to *Shenzhen Sheng Feng Yuan Industry Company Limited* (Sheng Feng Yuan) and other entities, and unauthorized exchange and purchase of foreign currency through ZHENG Xiaowei (prosecuted under a separate action) and the receipt of over HK\$822 million (or over US\$105 million) in Hong Kong.²³

21. KAO Shiu Guo "Success on Shell and Fail on Shell", China Academic Journal Electronic Publishing House, www.cnki.net, 2009.

22. The judgment of the first instance of HUANG Guangyu case (Full Version) - May 18, 2010. <http://finance.sina.com.cn/stock/s/20100519/22117970228.shtml>

23. *Ibid.*

2. *Crime of Insider Trading and Divulging of Inside Information*

During the period from April 2007 to June 28, 2007, Huang abused his official position as the controlling shareholder and director of *Beijing Centergate Technology Company Limited* by deciding and ordering others to buy in over 9.76 million *Beijing Centergate* shares in cumulative trading, for a total price of more than RMB\$93.1 million during the period from April 27, 2007 through June 27, 2007 in connection with the contemplated asset swap between *Beijing Centergate* and *Beijing Eagle*, a company operated and managed by Huang. The buy transaction was made through securities accounts opened in the name of Mr. Long, Mr. Wang and another 4 persons, with actual control of Huang, and when the relevant public announcement was made on June 28, 2007, the book earnings of the 6 securities accounts stood at more than RMB\$3.48 million.²⁴

During the period from July or August, 2007 to May 7, 2008, Huang decided and ordered others to buy over 104 million *Beijing Centergate* shares in cumulative trading for a total price of more than RMB\$1.322 billion during the period from August 13, 2007 through September 28, 2007 in connection with the contemplated 100% equity acquisition by *Beijing Centergate* of *Beijing Pengrun Property Development Holding Company Limited* and related restructuring. The buy transaction was made through securities accounts opened in the name of CAO Chujian, LIN Jiafeng and another 77 individuals, the trading through those securities accounts was however under the actual control of Huang, and when the relevant public announcement was made on May 7, 2008, the book earnings of the 79 securities accounts stood at more than RMB\$306 million.²⁵

3. *Crime of Corporate Bribery*

As a principal officer of the Defendant Entities *Pengrun Property* and *Gome*, Huang directed XU Zhongmin to request illegal favors from XIANG Huaizhu during the period from 2006 through to 2008 in connection with the handling of relevant cases involving *Pengrun Property* and *Gome*, and Huang offered, or directed XU Zhongmin to offer, XIANG Huaizhu payment and other valuables

24. *Ibid.*

25. *Ibid.*

in a total amount of over RMB\$1.06 million on two separate occasions.²⁶

B. The Second Instance Judgment

The second instance judgment was announced at the court house of Beijing Higher People's Court the morning of August 30, 2010. The court upheld the first instance court ruling of joinder punishment for the three counts of offences of Huang, including a jail term of 14 years, with fines and confiscation of properties totaling RMB\$800 million. The first instance ruling against Huang's wife, DU Juan, was revised to probation for a jail term of 3 years with stayed execution, and was released at the courthouse.²⁷

C. The Final Judgment from the Supreme People's Court

The China Supreme People's Court on May 22, 2012 declared their sentence on HUANG Guangyu and his wife DU Juan. The sentence on Huang was retained at jail term of 14 years, but fines were revised to RMB\$600 million and confiscation of properties totaling RMB\$200 million. For Huang's wife DU Juan, her jail term was increased to 3 years and 6 months with fines of RMB\$200 million.²⁸

In this case, HUANG Guangyu was sentenced to a jail term of 14 years, and he is currently serving the sentence. The end of this case should serve to be the beginning of insider trading regulatory awareness in China. The most relevant issue for this case is that it has raised the awareness for the interest of small/medium investors in China.

V. ISSUES FOR THE INVESTORS IN CHINA

After the court sentenced judgments for respective defendants from Huang's case, we should not forget there is another important party involved, the shareholder/investors. Shareholders are another major party who suffered in cases such as HUANG Guangyu, as the share price of *Gome* had plummeted during the period of this case. Besides *Gome* shareholders, other companies involved in this case are also public trading companies such as *Yongle*, *Sanlian Commercial* and *Beijing Centergate* and their share prices also reacted turbu-

26. *Ibid.*

27. The judgment of the second instance of Huang Guangyu case, Report. August 30, 2010. <http://finance.sina.com.cn/stock/tshgy/index.shtml>

28. People's Daily, <http://www.people.com.cn>, May 22, 12, China.

lently during the proceeding of this case.²⁹ In other words, there should be a large number of shareholder/investors who had suffered losses under the insider trading dealings of this case. As illustrated in Huang's case, this is the infamous consequence of shell listing as it is usually the small/medium shareholders/investors that suffer the most when insider trading occurred under shell listing. This is because the unfair and non-transparency of information usually led the major shareholder or company controller such as Huang to make substantial and unlawful profit at the expense of individual shareholders/investors.

In order to address this issue, pursuant to the Civil Procedural Law of the People's Republic of China, the court at the domicile of the plaintiff, i.e. shareholders who had suffered losses, shall have jurisdiction. However, in the Huang's case, tens of thousands of shareholders suffered losses as a result of Huang's insider trading, and were the courts at the domicile of the plaintiffs to have jurisdiction, there would be dozens of courts around the country that would docket the case and try the insider trading case against Huang. Due to the differing levels of trial quality and the varying standards applied, the results of the individual trials would differ significantly for this new type of case involving civil compensation for victims of insider trading, which is bad for maintaining the authority of court judgments, not to say the great waste of judicial resources. Therefore, there should be a single court to try and exercise jurisdiction over the claim. Tentatively, the trial court of the case could be the court at the domicile of the defendant.³⁰

If the Beijing Second Intermediate People's Court is to have jurisdiction over the civil compensation case for the insider trading offence, it would facilitate the finding of facts and the safeguarding of the legitimate interests of the investors. In light of the Huang's case, some people suggest that as Huang has permanent domicile in Hong Kong, and the first instance trial of the criminal case for the insider trading offence was made by the Beijing Second Intermediate People's Court. Therefore, Beijing Second Intermediate People's Court is the most appropriate forum.³¹

29. Bloomberg Professional System: Bloomberg Finance LP, USA: Beijing Centergate Technologie's share price has plummeted from the highest of RMB\$17.8 in May 2008, all the way down to RMB\$2.48 on November 4. And it has 130,000 shareholders.

30. "From Final Ruling of Huang's Case to Discuss the Issue of Civil Compensation for Insider Trading" <http://blog.p5w.net/?uid-382850-action-view-space-itemid-348215>, January 29, 2011 (Interview)

31. *Ibid.*

Now that we have addressed the issue of proper forum, let's look at another important issue, i.e. plaintiffs with good standing, in other words, which investors have the right to bring a compensation claim? Are all shareholders who sold shares during these two periods plaintiffs with good standing?

The Securities Law of 2005 has no explicit provisions regarding the scope of the plaintiffs, and it only provides that "where the insider trading causes losses to investors, the offender shall be held duly liable for indemnification".³² Should the word "investor" be given a broad meaning or a narrow meaning, does the word "investor" only include natural persons or also include victimized investment companies? If China wants to establish a more comprehensive framework of insider trading regulation, then the scope of qualified investors should be expanded to include victimized investment companies, because the purpose of compensation for insider trading offenses is to indemnify the victims, and punish the offender, and no distinction was made between natural person and corporations.

Specifically, according to the Criminal Judgment, it was during the period from April 27, 2007 to June 27, 2007 and the period from August 13, 2007 to September 28, 2007, the two price sensitivity periods, that Huang bought in huge amounts of *Beijing Centergate* stocks. Therefore, only shareholders who sold *Beijing Centergate* shares during these two periods might qualify as plaintiffs to claim against Huang; however, not all shareholders who sold shares during these periods are plaintiffs with good standing. Only shareholders who executed reverse trading as compared to that of Huang have good standing. It is worth stressing that "shareholders who executed reverse trading as compared to that of an insider" include all shareholders who executed reverse trading when the insider executed insider trading, and are not limited to counterparty to the executed share transactions of the insider. However, as the relevant authorities have not released the relevant information about Huang's insider trading, it is currently impossible to pinpoint the timing of Huang's purchase of shares. In this case, investors can analyze the trading volume of *Beijing Centergate* shares during these periods, especially during the period from August 13, 2007 to September 28, 2007 for any trading abnormality, and listed the relevant time windows, and investors who sold *Beijing Centergate*

32. Securities Times, China, "Issues on the Indemnification of Insider Trading from the Huang Guangyu Case" October 16, 2010.

stocks during those time windows may bring an action against Huang as a reference.³³

A. Method of Litigation

According to preliminary statistics, tens of thousands of investors are victims of Huang's insider trading. With such a large group of plaintiffs, which method of litigation would be more appropriate? The investors could be classified by their present state of mind as follows: (1) investors who are unaware of their right to sue Huang; (2) investors who are aware of such rights, but are not sure of the probability of winning the case, and they would rather stay as is if they could not recover losses through a lawsuit instead of incurring more litigation costs; and (3) investors who are not sure whether they could win the case, but are engaging a lawyer to try. The statistics show that the ratio of investors who are prepared to bring a lawsuit never topped 0.5% of the total number of shareholders, and most investors would rather not sue.³⁴

Investors suffered heavily as a consequence of this grave violation, then why are they choosing to waive the right of action? This may serve to be one of the weaknesses in the litigation mechanism in China. Pursuant to the Civil Procedural Law, where either side to an action is comprised of two or more parties and the subject matter of the litigation are identical or of the same type, joint litigation may be used. However, such joint litigation is only suitable where the identities of the plaintiffs are clear-cut, and the number of plaintiffs is relatively modest. A joint litigation could not work as well for such insider trading cases as the Huang's case where tens of thousands of plaintiffs are involved.

If joint litigation may not be an effective mechanism, some suggest the adoption of class actions. Class actions is a common investor protection mechanism in the United States and does have many advantages in bringing claims in massive tort cases, including trial economy, which helps avoid the exorbitant costs of individual action; deterrence, the massive damages payable in a class action helps prevent torts from occurring; protection of defendant, which helps protect the defendant from multiple punishment and from be-

33. Securities Times, China, "Issues on the Indemnification of Insider Trading from the HUANG Guangyu Case" October 16, 2010.

34. "Civil Compensation from Insider Trading from Huang's Caes", http://tech.ifeng.com/it/special/controlgome/content-1/detail_2010_09/18/2550894_1.shtml, February 1, 2011 (Interview).

ing overwhelmed with answering lawsuits. However, class action also has many shortcomings. First of all, class actions consume considerable time and costs, and in the U.S., only 8% of class actions could be concluded within one year, and only 2% to 3% completed the trial proceedings and a substantial part of the disputes are resolved by mediation or settlement. Second, class actions are led by lawyers designated by the judges, and the prospect of large legal fees often induced by the lawyers, for ulterior motives, to work with the defendant's counsel to settle with the plaintiffs, and the judges could not find a representative or lawyer who could truly represent the class. Third, massive damages and the involvement of huge amounts of resources, manpower and money often made the defendants unable to continue operations, or even file for bankruptcy.³⁵

Therefore, we should not directly copy the United States version of class action as it is, rather, we should adopt the rational elements of the class action method, and incorporate them into the joint action method of litigation that China already has, which in turn serves to be an effective recovery mechanism of insider trading losses, and promote the growth of the investor interests.

Also, we may suggest the use of representative action provided by Civil Procedural Law. However, the Several Circulars of the Supreme People's Court regarding the Trial of Civil Compensation Cases arising from False Representations in the Securities Market dated January 9, 2003 excluded representative action, and that is why representative action is rarely mentioned in connection with the trial of securities market cases.³⁶

However, in addressing civil compensation cases arising from insider trading, such representative action, with indefinite number of parties on either side is suitable in several aspects:

- (1) Representative action involving an indefinite number of participants as provided for in the Civil Procedural Law is suitable for cases involving the same type of subject matter, with many participants the number of whom could not be defined at the time of action. A vast majority of insider trading compensation cases meet such conditions;
- (2) Representative actions have advantages for the trial of insider trading compensation cases as the following:

35. LUI Jen "From CHENG Bai Wen's Case to See the Compensation got Civil Action in China" *China Finance*, 2006, Issue 4.

36. *Ibid.*

- a. In a representative action, the court could issue public announcements with a description of the case background and the claims, asking the right holders to register their rights and join the action, whereby truly encompassing various disputes into one proceeding for simultaneous resolution, which saves judicial costs and improves litigation efficiency.
- b. In a representative action, the method for the nomination of representatives are flexible, improving the likelihood of representative action, cutting the litigation costs of the parties and avoiding the litigation burdens of the defendant (mainly listed companies and their responsible persons).
- c. The judgment in a representative action could be expanded to apply to other stakeholders of the company involved besides shareholders who did not register their rights, ensuring the disputes are resolved once for all.

Therefore, the legislation should make it possible for resolution of civil compensation cases for insider trading by way of representative actions, which will help reduce litigation costs, improve litigation efficiency and maintain justice in the litigation process.³⁷

B. Standard of Compensation

An American scholar, Richard Posner, believes that civil compensation for securities offences are justified for two reasons. First, it provides incentives for victims to bring an action, because litigation is necessary in order to maintain the tort system as an effective deterrence against misdemeanors; second, it prevents the victims from taking excessive preventive measures.³⁸ This also points to the principles for the scope of compensation for securities related offences, first, the system is designed to provide adequate protection for the rights and interests of the investors on the basis of the causal effect between investment losses and insider trading, and holding and punishing the insider traders with civil liabilities, to prevent and deter insider trading; second, there shall be appropriate limitations of compensation liability, to prevent excessive deter-

37. CHIN Yen Yen "Research on Civil Compensation from Securities Market", Law and Social Development, China, 2008, Issue 4.

38. Richard Posner, CHIANG Yi Kang (translate), "The Economic Analysis of Law" China Encyclopedia Publishing Company, 1997, p.246

rence due to enormous compensation, as this will have a negative impact on social and economic development.

Some argue that the amount of compensation to investors should be calculated based on the earnings of the offender, for instance, in Huang's case, as of the announcement of relevant information, the book earnings of the securities accounts used by Huang for the insider trading stood at over RMB\$306 million, which should be the amount compensated to the investors, however, this method of calculation is not practicable for each investor and is broad in scope.³⁹ Therefore, the actual loss of each investor should be the basis for calculation of compensation.

The actual losses of investors include both direct losses, such as the losses due to the drop or rise of share prices, including relevant commission, stamp duty and closing costs, and indirect losses, including loss of interest, legal fees, litigation costs, travel expenses and cost of absence from work.⁴⁰ The current civil compensation regulations for violations in the securities market only stated the defrauder's liability for compensation of direct losses of investors, and ignored the investors' indirect losses, which is worthy of attention.

These are the primary methods for calculation of direct losses:

- (1) Actual value method: The amount of compensation is the difference between the actual price of the trading and the actual value of the securities at the time of such trading. For example, if an investor bought the concerned securities at RMB\$10 per share at the time of the insider trading, while the actual value of the securities is RMB\$8 per share at the time, the difference would be RMB\$2. However, under this method, the difficulty lies with the calculation of the actual market value of the securities at the time of the insider trading.
- (2) Calculation based on the actual cause, under which the insider trader is responsible for compensation against securities fluctuations caused by its trading activities, and that caused by other factors is not the responsibility of the insider trader. For instance, if an investor bought the con-

39. "Discussion on 8 Major Problems on the Civil Compensation for the Case of HUANG Guangyu" <http://finance.jrj.com.cn/biz/2010/09/0713438116630.shtml>, January 23, 2011 (Interview).

40. HSIANG Yi Tsai, HU Wen Hsin & CHANG Yi "The Determination for the Amount of Civil Compensation from Security Litigation" *China Market Journal*, Issue 52, 2007.

cerned securities at RMB\$10 per share at the time of insider trading, and after announcement of the inside information, the price of the securities is RMB\$8 per share, and of the RMB\$2 drop in per share price of the securities, RMB\$1 is caused due to system risks, and RMB\$1 is caused due to the insider trading, the insider trader will only be responsible for the RMB\$1 caused due to their actions. The difficulties with this method are how to distinguish insider trading action from other factors.

- (3) Differential price method: The amount of compensation is equal to the difference between the trading price and the share price at the time of announcement of the inside information or shortly after. The difficulties with this method are that it is hard to determine the time of announcement of the inside information and a reasonable period of time shortly thereafter.⁴¹

Among the above methods of calculation, the method of actual value is easier to use, and in practice, the actual value is determined based on the average price over a period of time, and tend to be adopted by courts and legislative authorities.

In Huang's case, the court used the closing price on the date of announcement of the relevant information as the basis for calculation of the gains made by Huang, and the investors could also use this method, i.e. the losses are calculated based on the difference between the closing price at the date of announcement and the sale price.

C. Evidence

The question of providing evidence for insider trading cases has always been a tricky issue as discussed in the previous work on *An Insight into Insider Trading in Greater China*, and in principle the burden of proof could be reversed, and for special cases of insider trading, some auxiliary measures may be taken.⁴²

In fact, many of the insider trading cases was discovered by investigation into corporate briberies. For instance, in the Huang's case, XIANG Huaizhu, the then vice director of the Economic Crime Investigation Department of the Ministry of Public Security

41. YANG Feng "Discussion on Determination for Compensation for Losses from Insider Trading" *Jinan Academic Journal*, Issue 6, 2006.

42. Greg Tzu Jan Yang "An Insight into Insider Trading in Greater China" *Maryland Series in Contemporary Asian Studies*, No. 1 – 2010(200)

and Head of Beijing Brigade for the Securities Crime Investigation, learned of inside information during the course of Huang's manipulation of *Beijing Centergate* shares, and bought *Beijing Centergate* shares in reliance of the inside information.⁴³ However during the trial against XIANG Huaizhu before Beijing Second Intermediate People's Court, the insider trading was not touched upon and it was the issue of bribery being focused for Xiang.

Therefore, a reward mechanism may be adopted for reporting of crimes, i.e. offering rewards to persons who report the offense. In addition, the employees of relevant securities regulatory authorities may be requested to appear before the court, or to provide relevant information as a witness for the prosecution.

D. Recovery of Damages

The facts of Huang's insider trading are clear, and the evidence is concrete, and there is no significant contention thereof, but if an adverse judgment in the civil compensation case is rendered against Huang, how will the recovery of damages end up? Would the once wealthiest person in China be able to deliver the compensation, and will the investors lose money despite their success in the case?

The investors should not be concerned with this issue, as the relevant regulations in China provide that civil compensations have priority over administrative and criminal fines.⁴⁴ The judicial authority has confiscated the *Beijing Centergate* shares, over 100 million shares in total, bought by Huang and his affiliated parties, which, at the recent average price of *Beijing Centergate* shares at RMB\$8 per share, is valued at nearly RMB\$900 million. If the court renders a favorable ruling for the plaintiffs in the civil compensation case, the confiscated shares would be adequate to compensate the claims of the investors, therefore recovery of damages amount would not be a concern in this case.

After years of criminal proceedings, Huang's insider trading case is basically settled, but the civil compensation proceeding has just begun. Huang's insider trading case is relevant as it is unprecedented in terms of the amounts, the scope and consequences, and is an important landmark in the development of the capital market in China. The analysis of the Huang case is not a mere analysis of the case itself or HUANG Guangyu the person, it is actually an analysis of the roads for safeguarding the interests of investors victimized by

43. The verdict of the initial trial of HUANG Guangyu case - May 18, 2010.

44. Article 207 of the "Security Law" and Article 14 of the "Torts Law".

insider trading, and is a summary of the common issues in the compensation cases against insider trading, to derive from the analysis reasonable solutions. Jurisprudence is not science, but the scientific method could be used to analyze legal issues and arrive at a scientific solution, which is also the purpose of our analysis.

VI. CASE ON QINGDAO KINGKING AND GUOYUAN SECURITIES

Even though the case on HUANG Guangyu had closed, insider trading cases continue to flourish in China's financial market in recent years. Not only has the structure of the cases become more complicated, but the scale and monetary profit involved also exceed Huang's case. For example, the case on *Qingdao Kingking Applied Chemistry Co Ltd* (Qingdao Kingking) and *Guoyuan Securities* should be considered a good example for insider trading cases in the post HUANG Guangyu era. Even though *Qingdao Kingking* and *Guoyuan Securities* are independent companies, they are related because they are both insider trading cases committed by the same person, SHIAO Shih Ching.

A. Backgrounds

The illegal structure for this case involves two major players, WANG Yi and SHIAO Shih Ching. They used to be members of China's CSRC, as CSRC was the governing body of the China security market; they use the connection and convenience of their position to gain insider information in profiting from the IPO of *Qingdao Kingking Applied Chemistry Co Ltd* and the corporate restructuring of *Hunan Jiuzhitang Co Ltd*. They are not only profiting for themselves, they have a group of affiliated parties to share the profit.⁴⁵

As for Shiao, his profit from insider trading on the *Guoyuan Securities* had profited him more than RMB\$100 million. This is a record breaking figure for the profit received from officials on insider trading cases. In other words, Shiao had used the convenience of his connections and position to commit two major insider trading cases that had profited him handsomely. One is *Qingdao Kingking* and the other is *Guoyuan Securities*.⁴⁶

45. TAN Yi Fei & CHANG Lu "The Reality of Shiao Shih Ching's Financial Dealing" (2011) CAACNews, China, May 13, Issue 4076, P1.

46. *Ibid.*

B. Facts on Qingdao Kingking

Qingdao Kingking originally was a Chinese artifact manufacturing company with capital of only USD\$200,000. As its Chairman CHEN Sou Bing wanted his company to go public, the company expanded its capital to RMB\$31.02 million on April 10, 2011. As Chen learned that his company does not quite qualify under the IPO criteria and regulatory body Development and Reform Commission rejected its IPO application, he approached the owner of *Tianching Ying Shun*, WANG Lai for assistance. Who is WANG Lai? He is CSRC vice chairman WANG Yi's brother. Due to his brother's position in CSRC, WANG Lai and his sister WANG Wei established *Tianching Ying Shun* on June 28, 2001 to provide technology development and investment consulting services with capital of RMB\$5 million.⁴⁷ The consulting services they provided usually focused on solving problems for companies who have troubles in qualifying or fulfilling CSRC's regulations or requirements. They will help these companies resolve their problems with CSRC using convenient and creative ways. On the other hand, they charge a handsome fee for sharing profits on IPOs from these companies.

As the sibling of Wang's family had engaged in a profiting framework, WANG Lai and WANG Wei used WANG Yi's position to attract business and WANG Yi used his sibling's company as a window to receive money from the corporate sectors. For example, during the period of November 1999 to February 2008, WANG Yi had received a bribe of RMB\$6.3 million from businessman CHOU Hong Ching in return for Chou's convenience in receiving credit line from the banks. This amount was received by WANG Lai for his brother. As WANG Yi became the vice chairman of CSRC in November 1995, he recommended SHIAO Shih Ching join the board of CSRC as deputy director - general of department of listed company supervision in 1996. Before that, Shiao was only a lecturer in the College for officers for Central Financial Administration and was new to the financial industry.⁴⁸

In 2006 *Qingdao Kingking* was having difficulties fulfilling the requirements for IPO, the chairman of *Qingdao Kingking* sought assistance from WANG Lai to resolve the difficulties for him. WANG Lai approached Shiao to do this favor for him. Even though at that time, Shiao had already left the CSRC board to be-

47. *Ibid.*

48. *Ibid.*

come the Chairman of *Galaxy Securities*, but his connections on the board were still intact.

To the market's surprise and with significant assistance from Shiao, the next day it was announced that the case for *Qingdao Kingking* IPO was passed and successfully IPO by December 2006 on the Shenzhen Stock Exchange. On one afternoon on December 2006, WANG Lai had given a gift of cash RMB\$200,000 to Shiao for his assistance and this gift was later presented as evidence of bribery that Shiao received in this case.⁴⁹

C. Facts on Guoyuan Securities

During Shiao's days as CSRC's deputy director - general of department of listed company supervision, he learned on 2004 that *China Petrochemical Corporation (Sinopec)* planned to restructure its public trading subsidiary into an integrated public company. By 2006, Shiao left CSRC and became the chairman in *Galaxy Securities*. By that time, *Galaxy Securities* was acting as financial consultant for *Sinopec* on the IPO of its subsidiaries. As a result, Shiao used this convenience to obtain knowledge on the timetable and information for the IPO. By September 2006, he confirmed that *Sinopec* will use *Everbright Securities Company Limited* as a shell (shell listing) for *Sinopec* subsidiary *Beijing Huaer Company Limited* to IPO. Once this IPO method was confirmed, Shiao used his friends and family members as dummy accounts to buy stock of *Beijing Huaer Company Limited* for the amount of RMB\$35 million or 430,000 shares between September 21 and 30, 2006.

On March 14, 2007, *Beijing Huaer Company Limited* confirmed to IPO under *Everbright Securities* and it will change its name to *Guoyuan Securities*. On October 30, the first trading day of *Guoyuan Securities*, its stock rallied 400% to as high as RMB\$50 and closed at RMB\$47.53. This IPO rally had made Shiao a profit of around RMB\$100 million and the court later demanded Shiao and his family members to return profits of RMB\$72.5 million as unlawful profits.⁵⁰

D. Judgments

The scope and amount of this case were both record high in China's financial market and Wang and Shiao bluntly using their position and connection in CSRC as a convenient mechanism for

49. *Ibid.*

50. *Ibid.*

profit had attracted attention from the Chinese regulator. On June 8, 2008 WANG Yi (CSRC ex-Vice Chairman) was taken into custody by Serious Crimes Squad for investigation. On April 29, 2009, SHIAO Shih Ching, the CEO of *Galaxy Securities* was under investigation and the investigation focused on his connections with the corporate companies and the securities market during his two terms as member of the CSRC board. By the end of April 2010, WANG Yi was sentenced to death parole for receiving bribes of RMB\$11.9 million by Henan Province People's High Court. By the end of April 2011, SHIAO Shih Ching was sentenced to death parole for bribery and insider trading at Final Instance by Henan Province People's High Court. Shiao was guilty for RMB\$15.46 million of bribery and insider trading profit of RMB\$100 million and return profit of RMB\$72.5 million as unlawful profits.⁵¹

E. Issues from the Cases

From these cases, we can see the biggest problem that leads to the insider trading dealing is the existence of the "amphibian" like Shiao and Wang who move between government regulatory bodies and securities firms. Unfortunately, they are not the only ones. According to a press survey, there are 28 fund managers in Chinese securities firms who used to work in the CSRC.⁵² They move between their roles to serve their own interest. On one hand, they relax regulations and convenience to IPO for their related companies and on the other hand, they and their family members profit from the capital market from the insider information. This amphibian role allows them to gain unlawful profit from the insider information they obtain as regulatory officials.

Unfortunately, in a healthy and mature capital market, these amphibians are not allowed to exist. Their mere existence opened an unfair window in the market and made the capital market imperfect and unhealthy. If China wants its capital market to become one of the major financial markets in the world like the United States and Japan, they should provide restrictions in regulating officials who retire or leave CSRC. There should be clear "revolving door policies" in restricting ex-CSRC officials to work in securities companies. Also, providing "revolving door policies" is not enough, enforcing them is the key. Without effective enforcement and punishment, all regulations will become a mere formality. The am-

51. *Ibid.*

52. *Ibid.*

phibian problem will continue to exist and the market will continue to be unfair.

F. Issue on Shell Listing

Besides the amphibian problem, another problem which emerged from the cases above was shell-borrowing listing. Shell listing is a common practice in China especially for Chinese companies to be listed in the Hong Kong or other stock market. This may be a convenient practice for the company to raise capital in the public market, but this practice also provides many loopholes for gaining insider information and room for insider dealing. As a result, the issue of shell listing will be closely examined and discussed as it is at present a special characteristic for insider trading cases in China.

1. *What is Shell-borrowing Listing?*

The mechanism of shell listing is often adopted when a Chinese company wants to be listed in their local or overseas stock market, and choose not to list directly but to buy or borrow the shell of another public trading company in that market. There are two major types of shell listing. There is the shell-borrowing listing and shell-making listing.

a. Shell-borrowing Listing

The Chinese company usually chooses an existing listed company to "borrow" the shell of that company in order to achieve the goal of raising capital in the market. The Chinese company will usually purchase the equity of the borrowed company in order to become the major holder of the company. After they gain control or purchase the company, they use the company as a shell for public listing. Usually after they purchase the company, they will inject their own assets into the shell company and achieve their ultimate goal of public listing.⁵³ Aside from acquiring a separate corporate entity for listing, shell borrowing could occur within the corporate group. In other words, a parent company could use one of its subsidiaries as a shell for listing. The parent company will inject assets and capital into the shell subsidiary and restructure it into a holding

53. ZHANG Yu, "Sample Analysis and Law Regulation to the Coming into Market of the Chinese Enterprises Through Shell-Borrowing Overseas" *Journal of Hebei University of Economics and Trade*, Vol. 21, No. 4, July 2000.

company and in turn help the parent company go public as a whole.⁵⁴

There are a few advantages for shell borrowing listing. First of all, this method is fast and convenient for the companies compared with standard IPO listing procedure for Chinese companies. This is because according to The Securities Law of The People's Republic of China, there are a list of strict requirements for IPO listing on market capital, ratio of public issued shares, number of shareholders and financial performance.⁵⁵ On the other hand, if they want to be a listed company and choose a listed shell company, they can avoid all the above requirements and achieve their purpose for listing quickly. As a result, shell listing provides a convenient back door for companies who want to be publicly listed but cannot fulfill the requirements for listing under the Securities Law. Also, if a company chooses to follow standard IPO procedure, the whole process until public listing could take around 18 months. On the other hand, even though shell listing requires complicated financial restructuring between the parent and shell company, it usually will take around 6 months to complete till listing.⁵⁶

Secondly, the cost to be listed is lower for a second offering of the shell company compared with IPO listing. In order to protect the interests of the investing public, the Securities Law set up higher thresholds on the cost of IPO listing. The to-be listed company has to provide a series of expenses from listing preparation to actual listing. On the other hand, the cost for a second offering on the restructured shell company is much lower than the IPO listing. This has become another important incentive for companies to choose shell listing.⁵⁷

Thirdly, this method could also be used to avoid the problem of a difference in accounting methods between Chinese companies and overseas markets. As a result, this method has become a popular listing mechanism for Chinese companies to be listed in Hong Kong and New York Stock Exchange.⁵⁸

54. ZHAO Lei, "Research on Legal Risk Control of Back-door Listing", Journal of Anhui Vocational College of Police Officers, General No. 54, Vol.10, No. 3, 2011.

55. The Security Law of PRC, sections for IPO listing.

56. ZHAO Lei, "Research on Legal Risk Control of Back-door Listing", Journal of Anhui Vocational College of Police Officers, General No. 54, Vol.10, No. 3, 2011.

57. *Ibid.*

58. ZHANG Yu, "Sample Analysis and Law Regulation to the Coming into Market of the Chinese Enterprises Through Shell-Borrowing Overseas" Journal of Hebei University of Economics and Trade, Vol. 21, No. 4, July 2000.

From the advantages mentioned above, shell listing seems to be a win-win solution for both shell and borrowing company. This is because the potential shell companies are usually public traded companies that are inactive, have low transparency and low future visibility, the injection of new assets and capital into the shell company provided them with an opportunity to get rid of problematic old assets and restructure its own financial structure.⁵⁹ Also, there is also a potential bid rally on the shares of the shell company. This is also an opportunity for existing shareholders of the shell company to get rid of their non-performing old investment and profit in the market. On the other hand, as the cases mentioned above, this bid rally will also become a potential opportunity for insider trading to occur. This is also the reason that gives shell listing a bad name.

According to the advantages mentioned above, there are a few successful cases under shell listing. The following are a few popular examples:

- In February, 1990, the Hong Kong subsidiary of *China International Trust and Investment Corporation (Citic Group)*, *Citic Hong Kong* wanted to be listed in the Hong Kong stock market through shell listing, so they acquired 43% equity of *Taifu Development Co Ltd* an existing listed company in Hong Kong and to be newly listed as *Citic Pacific* in January 1991. After the purchase, the parent company *Citic Group* continued to inject capital into this company and made it become one of the 33 members in the Hong Kong Heng Sang Index.
- In October, 1992, Chinese State Owned Enterprise, *Shogang Group* and Hong Kong company *Cheung Kong (Holdings) Limited* in joint venture to acquire a Hong Kong listed company *Tung Wing Steel Holdings Limited*. Afterward, *Cheung Kong (Holdings) Limited* transferred most of its *Tung Wing Steel Holdings Limited's* shareholdings to *Shogang Group* and the company was renamed to *Shougang Concord International Enterprises Company Limited*. This not only enabled *Shogang Group* to be listed in Hong Kong market, but the capital gain on *Tung Wing Steel Holdings Limited* from HKD\$0.928 to HKD\$2.77, had enabled *Shogang Group* to acquire this shell without using its own cash. Not only that, this shell borrowing listing enabled *Shogang*

59. ZHAO Lei, "Research on Legal Risk Control of Back-door Listing", Journal of Anhui Vocational College of Police Officers, General No. 54, Vol.10, No. 3, 2011.

Group to acquire HKD\$1.8 billion in cash. The huge success for *Shogang Group* had become a success story for shell borrowing listing and became a huge temptation for Chinese companies who wanted to be listed in Hong Kong.⁶⁰

On the other hand, besides the advantages and success stories mentioned above, there are also disadvantages of shell-borrowing listing. First of all, the cost of buying a shell may be unpredictable. Even though the expense on second offering is lower than IPO listing, the cost of actually acquiring the shell of a listed company could be much higher than normal listing. For example, if the news of shell borrowing-being spread in the market, the share price of the shell could rally and increase the cost of shell purchases. Also, the risk of shell-borrowing listing could be much higher than normal listing. This is because Chinese companies usually not familiar with overseas market such as Hong Kong. Even though they have underwriters in the securities companies in helping them to choose target shell companies and undergoing comprehensive evaluations, there is still a risk that they purchase a problematic shell company. When they purchase a problematic company, they are not only unable to be listed successfully, they even have to undertake the unwanted liabilities of the shell company.

As a problem with shell-borrowing emerges gradually, China CSRC in February, 1994 introduced *The paper in relation to exam and approval domestic enterprise issuing stock in overseas market*. This indicated that when Chinese companies want to be listed overseas, it has to be approved by the *State Council Securities Commission*, or else shell-borrowing listed will not be allowed.⁶¹ As regulations for shell-borrowing listing become stricter and companies can be chosen as a shell become scarcer, Chinese companies are choosing a new revised method of shell listing: shell-making listing.

b. Shell-making Listing

Shell-making listing occurred when Chinese companies registered a newly formed company in the market planned to be listed or in a third region. The new company could either be solely owned

60. ZHANG Yu, "Sample Analysis and Law Regulation to the Coming into Market of the Chinese Enterprises Through Shell-Borrowing Overseas" *Journal of Hebei University of Economics and Trade*, Vol. 21, No. 4, July 2000.

61. ZHANG Yu, "Sample Analysis and Law Regulation to the Coming into Market of the Chinese Enterprises Through Shell-Borrowing Overseas" *Journal of Hebei University of Economics and Trade*, Vol. 21, No. 4, July 2000.

or jointly owned by the Chinese company as a holding company. For example, a Chinese company may form a solely or jointly owned holding company in a third region such as Bermuda, Cayman Island or British Virgin Island. In return, this holding will purchase the shares of the Chinese company as its holding company and this holding company can choose a desired market to be listed such as Hong Kong. During the process of shell making, choosing which place to be registered depends on the rules and regulation of the market they plan to be listed.⁶²

As shell-making has also become a popular method for Chinese companies to raise capital from a public market. Shell-making has its advantages as well. The advantages are:

- Shell-making listing has lower cost and lower risk compared with shell-borrowing. This is because the company does not need to take the risk of buying a problematic shell company. Also, the cost to register a new company in a third region should be much lower than purchasing the shares of a shell company.
- Since China's own accounting, auditing and legal standards are generally different to international standards; registering the new company in a third overseas region ensures that it will be accepted by the market it planned to be listed.⁶³

On the other hand, there are also disadvantages to shell-making listing. First of all, the Chinese company needs to use a significant amount of capital to remit to overseas to establish the new company. This may be a huge financial burden for the company. Second, is time consumption, as it may take a few years from company register to public listing in the overseas market. This is because the regulatory authority of the listing market usually requires companies registered in places such as Cayman Island or BVI to be operated for a few years before they qualify for public listing. This is used to avoid a paper company becoming a public listed company.⁶⁴

G. Problems Arise from Shell Listing

As illustrated from by the above analysis, Chinese companies need mechanisms such as shell listing as a convenient means for them to raise capital in the public or overseas public market. Also,

62. *Ibid.*

63. *Ibid.*

64. *Ibid.*

the standard for shell listing is much lower than formal IPO listing. As it is much easier for the company to acquire a shell company, inject capital and restructure the company and IPO the shell company than to follow all the formal IPO listing standards by themselves.

On the other hand, the widely used shell listing such as cases mentioned above does lead to some problems. The problems are as follows:

- Legal and regulatory problem: Chinese companies are often unfamiliar with overseas legal systems, regulations and lack experience in dealing with overseas legal regulators. This could create huge losses or even lead to complete failure during the shell-borrowing or making process.
- Higher than market cost: During the process of shell listing, Chinese companies may spend too much capital on purchasing or making the shell that may lead to a shortage of its own operating capital and create a problem with its own operation. This may occur when a Chinese company may use a huge amount of money to bid for a shell company. For example, the potential shell companies in Hong Kong are usually public traded companies that are inactive, has low transparency and low future visibility company with very low share price. With shell listing becoming a popular listing method for Chinese companies to list in Hong Kong, the potential shell companies in Hong Kong are becoming popular targets for Chinese companies. There may be a few Chinese companies who have become active bidders for those potential shell companies and its shares rally to be much higher than its fair value. As a result, when the Chinese company finally gets the shell company, the bidding process may make it pay a few more times on the share prices than its fair market value.
- Dual accounting book: When a Chinese company finally creates the listed shell companies, the shell company usually has two sets of accounting books. As for a shell listed company in Hong Kong, an outer accounting book is kept to fulfill the accounting and auditing requirement of Hong Kong regulators. An inner accounting book is the actual accounting book that records the actual financial and operating activities of the company. The existence of two accounting books might create the opportunity of a loophole for operating and man-

- agement officers to transfer capital and assets for their own interest or room for accounting fraud and corruption.
- Legal control on assets: There is lack of comprehensive legal regulations to monitor the assets of Chinese companies in the listed shell company. This is because some of the Chinese companies listed in Hong Kong are state owned enterprises. When they are listed in Hong Kong through shell listing, Chinese stated owned assets sometimes are being transferred to private hands without any legal regulation to monitor.⁶⁵
 - Window of opportunity for insider trading to occur: As the shares of potential shell companies may rally as Chinese companies actively bid for their control, this is becoming an opportunity for insider trading to occur. As mentioned above, the shares of potential shell companies are mostly inactively traded and low valuation, the bid rally makes this type of companies to be attractive targets for insider trading. The insiders are usually major stakeholders of the deal such as securities underwriters and major shareholders of the potential shell companies or bidding companies are usually the insider to acquire firsthand information of the potential bid. They can easily make a handsome profit in the market by trading during the bid rally. This is being illustrated during the case of Huang and Shiao. Once the stakeholders on the deal acknowledge on the bid, they can easily leak the information to their friends and relatives to profit from the deal.

H. Remedies and Regulations for Shell Listing:

1. Remedies

Despite all the problems illustrated above for shell listing, shell listing indeed is an effective and convenient resolution for Chinese companies to list in the public market, especially in overseas capital markets. In order to utilize the advantages of shell listing and avoid its related problems, there are a few points which need to be focused on in order to provide a remedy for the problem on shell listing.

- Careful selection of potential shell company: When a company decides to choose shell listing as their method of listing,

65. ZHAO Lei, "Research on Legal Risk Control of Back-door Listing", Journal of Anhui Vocational College of Police Officers, General No. 54, Vol.10, No. 3, 2011.

they should choose the appropriate potential shell company carefully. They should choose a shell company which will not only provide them with a shell, but also provide them with the operational and financial resources they needed. They should choose a shell that could maximize their benefits on their capital structure for public listing.

- Limiting on related parties trades: According to The Listing Rules of Shanghai and Shenzhen Stock Exchange, related parties transaction means the transactions that related legal persons, related natural persons and potential related parties had transfer resources in order to directly or indirectly gain control over a public company or its holding subsidiaries. During the shell listing process, the unlisted company gains equity and control of a public listing shell company either through equity exchange, resources exchange should be considered a related parties transaction. Hence, it should be regulated and governed by regulations in the stock exchange on related party transaction. If regulated effectively, it could be used to avoid unlawful profit to occur as the unlisted company gaining control of the public company and using their position of control to exchange their low quality asset with more valuable asset of the public shell company in order to strip the asset of the shell company.⁶⁶
- Protect the interests of small/individual shareholders/investors: Due to un-equivalent of information, small investors usually become the victims of the controlling/major shareholder's profit taking. On the other hand, it is important that the interests of small/individual investors' interest should be addressed and protected. This is because:
 1. Due to the defects of the financial market, this often leads to unfair information and major shareholders controlling the board of directors. As a result, the small investors have no voice or control in the capital market. Their interests are often being overlooked.
 2. Small and individual investors are an important part of capital resources for the company's survival. A public company can not only survive on major shareholder and without help from small investors.

66. *Ibid.*

3. To protect the interests of small investors is important to the prosperity and stability of a financial market.⁶⁷
- Establish a complete and competent relevant information disclosure system: A complete and competent information disclosure system is the fundamental requirement to protect the small individual/investor's rights to relevant financial information. The Section 86 of the current Security Law of PRC, with the 5% threshold for relevant information disclosure. Unfortunately, with the current capital market conditions and increase in liquidity of the stock market, the 5% threshold may not be enough. As a result, China can take the example of U.S. with the disclosure of 5% and +/-1% will be required for disclosure.⁶⁸

2. Regulations

In another words, regulations targeted on shell listing mechanism are indeed needed in order to avoid problems related to shell listing to emerge. As a result, starting on September 1, 2011, CSRC declared the formal implementation of *the Decision on Revising the Relevant Provisions on Major Asset Reorganization and Supporting Financing for Listed Companies* or "*the decision*". According to *the decision*, it not only clearly specified the scope and method of supervision for shell listing; it also introduced additional requirements on *Administrative Measures for Material Assets Reorganization of Listed Companies*. This is used to introduce specific requirements for operation management, operation timing and profit management on shell companies. For example, *the decision* has raised the threshold for asset restructuring on shell listing. *The decision* specified the company should operate and manage the shell company continuously for more than 3 years and the shell company should operate at a profit of more than RMB\$20million for more than two consecutive accounting years. According to the requirement of 2006, *Opinions on the Application of Securities and Futures Laws* for normal IPO, the listing company should operate at a profit of more than RMB\$30million for more than three consecutive accounting years. In other words, after the implementation of *the de-*

67. CHOW Chin Yen "The Protection for Small/Medium Investors under Shell Listing Process" China Academic Journal Electronic Publishing House, <http://www.cnki.net>, 2011, March.

68. *Ibid.*

cision, the standard for shell listing is becoming close to the standard of normal IPO listing.⁶⁹

In order to avoid the occurrence of related parties transaction and insider trading related to shell listing, CSRC decided to issue a series of decisions such as *the Release of Suggestions on Strengthening the Supervision of Listed Companies*, *the Notification on the Regulation on Major Purchase or Selling of Large Assets buy Listed Companies*, *the Administrative Measures for the Takeover of Listed Companies*, *Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies*, *Administrative Measures for Material Assets Reorganization of Listed Companies*, *Regularizing the Information Disclosure of Listed Companies and Behaviors of Relevant Parties*.⁷⁰ This series of regulations and decisions are used to focus on the related parties and insider trading problems on shell listing that are detrimental to the market competence and investor confidence in the stock market.

This is the first time China's regulators introduced regulations that focused on regulating shell listing. Before "the decisions" were introduced, the listing standards for shell listing were much lower than standard IPO. As a result, when a company purchased a shell company, they can inject capital and restructure the financial structure of the shell company in a short period of time. As the process of restructuring and chain of decision is often complicated, it is easy to hide illegal activities such as insider trading and related parties-dealing during the process.⁷¹

On the other hand, as the introduction of "the decision" made the requirement for shell listing stricter and increased the transparency for shell listing, it is also likely to reduce shell listing in the future and encourage Chinese companies to follow the formal standards of IPO listing. Even though insider trading often related to shell bidding and listing, but there are indeed some advantages related to shell listing and it is unlikely that the shell listing mechanism will disappear in the financial market. As a result, the

69. LU Bing "Shell Listing Required Stricter and More Comprehensive Regulations" Capital and Law, China Academic Journal Electronic Publishing House, <http://www.cnki.net>, 2011, September.

70. ZHAO Lei, "Research on Legal Risk Control of Back-door Listing", Journal of Anhui Vocational College of Police Officers, General No. 54, Vol.10, No. 3, 2011.

71. LU Bing "Shell Listing Required Stricter and More Comprehensive Regulations" Capital and Law, China Academic Journal Electronic Publishing House, <http://www.cnki.net>, 2011, September.

regulator should provide effective regulations for this mechanism rather than limiting it to occur.

VII. INSIDER TRADING IN THE U.S.A

In the United States and several other jurisdictions, trading conducted by corporate officers, key employees, directors, or significant shareholders (in the U.S., defined as beneficial owners of ten percent or more of the firm's equity securities) must be reported to the regulator or publicly disclosed, usually within a few business days of the trade. Many investors follow the summaries of these insider trades in the hope that mimicking these trades will be profitable. While "legal" insider trading cannot be based on material non-public information, some investors believe corporate insiders may have better insight into the health of the company or its financial performance. As a result, their trades may convey important information. On the other hand, the existence of legal insider trading has always been considered to be a grey area as it is only one line to consider being legal or illegal concerning insider trading.

A. Illegal

What attracted the concern of legal authorities or the financial market is the existence of illegal insider trading. Rules against insider trading on material non-public information exist in most jurisdictions around the world, though the details and the efforts to enforce them vary considerably. In the United States, insider trading is regulated by Sections 16(b) and 10(b) of the Securities Exchange Act of 1934 which directly and indirectly addresses the issue. Congress enacted this act after the stock market crash of 1929.⁷² The United States is generally viewed as the one of the first and having the strictest laws against illegal insider trading, and makes the most serious efforts to enforce them.

1. Definition of "insider"

In the United States and Germany, for mandatory reporting purposes, company insiders are defined as a company's officers, directors and any beneficial owners of more than ten percent of a class of the company's equity securities. Trades made by these types of insiders in the company's own stock, based on material non-public information, are considered to be fraudulent since the insiders

⁷² *Speech by SEC Staff: Insider Trading - A U.S. Perspective* by Thomas C. Newkirk, Associate Director, Division of Enforcement (September 1998)

are violating the fiduciary duty that they owe to the shareholders. The corporate insider, simply by accepting employment, has undertaken a legal obligation to the shareholders to put the shareholders' interests before their own, in matters related to the corporation. When the insider buys or sells based upon company owned information, he or she is violating his/her obligation to the shareholders.⁷³ For example, illegal insider trading would occur if the chief executive officer of Company A learned (prior to a public announcement) that Company A will be taken over, and bought shares in Company A knowing that the share price would likely rise.

In the United States and many other jurisdictions, however, "insiders" are not just limited to corporate officials and major shareholders where illegal insider trading is concerned, but can include any individual who trades shares based on material non-public information in violation of some duty of trust. This duty may be imputed; for example, in many jurisdictions, in cases of where a company insider "tips" a friend about non-public information likely to have an effect on the company's share price, the duty the company insider owes the company is now imputed to the friend and the friend violates a duty to the company if he or she trades on the basis of this information. For example in the case of Rajaratnam and Gupta, Gupta as director of Goldman Sachs was found to be guilty of insider trades as he tips his friend Rajaratnam of Goldman Sachs's earnings result before this information is released to the public.

2. *Misappropriation theory*

A newer view of insider trading, the "misappropriation theory," is now part of U.S. law. It states that anyone who misappropriates (steals) information from their employer and trades on that information in ANY stock (either the employer's stock or the company's competitor stocks) is guilty of insider trading.⁷⁴ For example, if a fund manager who worked for Company B learned about the takeover of Company A while performing his work duties, and bought stock in Company A personally, illegal insider trading might still have occurred. Even though the fund manager did not violate a fiduciary duty to Company A's shareholders, he might have vio-

73. Wikipedia on Insider Trading: http://en.wikipedia.org/wiki/Insider_trading

74. Larry Harris, *Trading & Exchanges*, Oxford Press, Oxford, 2003. Chapter 29 "Insider Trading" p. 586-587

lated a fiduciary duty to Company B's shareholders (assuming the investment fund had a policy of not allowing fund manager to trade for themselves).

3. *Proof of responsibility*

Proving that someone has been responsible for a trade can be difficult, because traders may try to hide behind nominees, offshore companies, and other proxies. Nevertheless, the U.S. Securities and Exchange Commission (SEC) prosecute over 50 cases each year, with many being settled administratively out of court.⁷⁵ The SEC and several stock exchanges actively monitor trading, looking for suspicious activity.

B. The Insider Trading Law of the U.S.A.

As United States has been the leading country in prohibiting insider trading made on the basis of material non-public information. Thomas Newkirk and Melissa Robertson of the U.S. Securities and Exchange Commission summarize the development of U.S. insider trading laws. Insider trading has a base offense level of 8, which puts it in Zone A under the U.S. Sentencing Guidelines. This means that first-time offenders are eligible to receive probation rather than incarceration.⁷⁶

1. *Common Law*

U.S. insider trading prohibitions are based on English and American common law prohibitions against fraud. In 1909, well before the Securities Exchange Act was passed, the United States Supreme Court ruled that a corporate director who bought that company's stock when he knew it was about to jump up in price committed fraud by buying while not disclosing his inside information.

Section 15 of the Securities Act of 1933 contained prohibitions of fraud in the sale of securities which were greatly strengthened by the Securities Exchange Act of 1934. Section 16(b) of the Securities Exchange Act of 1934 prohibits short-swing profits (from any purchases and sales within any six month period) made by corporate directors, officers, or stockholders owning more than 10% of a firm's shares. Under Section 10(b) of the 1934 Act, SEC Rule 10b-5, prohibits fraud related to securities trading.

75. Wikipedia on Insider Trading: http://en.wikipedia.org/wiki/Insider_trading

76. *U.S.S.G. §2B1.4*

The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 provide for penalties for illegal insider trading to be as high as three times the profit gained or the loss avoided from the illegal trading.

SEC regulation FD ("Fair Disclosure") requires that if a company intentionally discloses material non-public information to one person, it must simultaneously disclose that information to the public at large. In the case of an unintentional disclosure of material non-public information to one person, the company must make a public disclosure "promptly."⁷⁷ Insider trading, or similar practices, are also regulated by the SEC under its rules on takeovers and tender offers under the Williams Act.⁷⁸

The most recent development in regulating the insider trading is the Dodd-Frank Act. This act was passed on July 31 2011 focusing on financial regulations and insider trading activities in the post-global financial crisis world. The Act changes the existing regulatory structure, such as creating a host of new agencies in an effort to streamline the regulatory process, increasing oversight of specific institutions regarded as a systemic risk, amending the Federal Reserve Act and promoting transparency. The Act purports to provide rigorous standards and supervision to protect the economy and American consumers, investors and businesses and to end taxpayer funded bailouts of financial institutions, claim to provide for an advanced warning system on the stability of the economy, creates rules on executive compensation and corporate governance, and eliminates some loopholes that led to the 2008 economic recession. Under this Act, important new agencies created include Financial Stability Oversight Council, the Office of Financial Research and the Bureau of Consumer Financial Protection. Of the existing agencies, changes are proposed ranging from new powers to the transfer of powers in an effort to enhance the regulatory system. On the other hand, even though the Act was being passed, but the implementation details of this Act was still in discuss with various financial participants such as SEC, Chicago Mercantile Exchange (CME) and Commodity Futures Trading Commission (CFTC).⁷⁹

77. Larry Harris, *Trading & Exchanges*, Oxford Press, Oxford, 2003. Chapter 29 "Insider Trading" p. 591-597

78. http://en.wikipedia.org/wiki/Williams_Act

79. Dodd-Frank Wall Street Reform and Consumer Protection Act

VIII. THE INSIDER TRADING CASES OF RAJARATNAM, GOFFER AND GUPTA

Besides, laws and regulations, much of the developments of insider trading law has resulted from court decisions. U.S. securities regulators initiated a crackdown on insider trading activities since 2007. As a result, the most significant developments are the cases on Rajaratnam, Goffer and Gupta. These three cases are complicated and inter-related, but their convictions are considered one of the most important victories of financial regulator against insider trading.

A. Facts

On October 16, 2009, United States Securities and Exchange Commission (SEC) sued Raj Rajaratnam for engaging in insider trading. Also, Rajaratnam, the billionaire founder of Galleon Group was among six people who were arrested and charged in a US\$20 million insider trading scheme under federal prosecution. Besides Rajaratnam, prosecutors also arrested Rajiv Goel, director in Intel Capital strategic investments, Anil Kumar, director at McKinsey & Co., IBM Corp executive Robert Moffat, Danielle Chiesi and Mark Kurland, fund manager at New Castle Partners.⁸⁰ Federal investigation had this case for more than two years in the making and among the biggest undercover operations in insider trading. By November 6, 2009, US prosecutors charged another fourteen people, including hedge fund managers, lawyers and ex-Galleon Group employees with method dealing with drug dealers and common criminals as they profited on insider data from deals involving firms such as 3Com Corp and Alliance Data System Corp. These additional charges had brought the combine illegal profits in these cases from US\$20 million to as much as US\$53 million.⁸¹

The investigation did not stop by the unraveling of these two insider trading rings. By March 2010, the prosecutors were examining the trades in Goldman Sachs shares by Rajaratnam. The former Goldman Sachs board member, Rajat Kumar Gupta was also being examined and later arrested as he was a onetime business partner with Rajaratnam. Gupta was a board member of Goldman Sachs since November 2006 and only ceased to be on the board three days

80. David Glovin, Katherine Burton & David Scheer "Galleon's Rajaratnam Charged in Biggest Hedge Scheme" Bloomberg, L.P; Oct. 16, 2009.

81. David Glovin, Bob Van Voris & Joshua Gallu "Hedge Fund Managers, Traders Charged in Galleon Trading Probe" Bloomberg, L.P, November 6, 2009.

before the prosecutor announced their investigation.⁸² On Oct. 26, 2011 Gupta was charged with 5 counts of securities fraud and one count of conspiracy to commit securities fraud.⁸³ The SEC filed its lawsuit the same day, accusing Gupta of engaging in an extensive insider trading scheme with Rajaratnam.⁸⁴ On June 15, 2012, Gupta was found guilty of securities fraud and conspiracy. Securities fraud carries a maximum prison sentence of 20 years and conspiracy carries a five year maximum.⁸⁵

Rajaratnam faces 13 fraud and conspiracy counts and many carry 20-year maximum sentences. On October 13, 2011 he was sentenced to 11 years in prison for insider trading.⁸⁶ He was also ordered by the federal judge to pay US\$92.8 million for the case brought by the U.S. Securities and Exchange Commission (SEC).⁸⁷ The six defendants were charged with using insider trading information in the above two overlapping schemes to trade shares of companies including Google Inc., Polycom Inc., Hilton Hotels Corp and Advanced Micro Devices Inc (AMD). They were arrested under the insider trading scheme as trading tips to Rajaratnam since 2006 came from insiders and others at hedge funds, investor relations firms, and companies including Intel, IBM, McKinsey, and companies whose shares were traded in the scheme. Under this scheme, Rajaratnam and his firm had earned around \$23 million from the fraud.⁸⁸

B. Rajaratnam: October 16, 2009

This is a case of hedge fund insider trading as Rajaratnam founded Galleon in January 1997 and focusing on technology and health-care stocks. Galleon had grown to US\$5 billion in 2001 and

82. John Helyar, Mehul Srivastava & David Glovin "Goldman Sachs Director Gupta Dealt with Rajaratnam" Bloomberg, L.P, April 22, 2010.

83. U.S. v. Gupta, 11-cr-00907, U.S. District Court for Southern District of New York (Manhattan).

84. SEC v. Gupta, 11-cv-07566, U.S. District Court for the Southern District of New York (Manhattan)

85. U.S. v. Gupta, 11-cr-00907, U.S. District Court for Southern District of New York (Manhattan).

86. U.S. v. Rajaratnam, 09-02306, U.S. District Court, Southern District of New York (Manhattan).

87. SEC v. Rajaratnam, 09-cv-8811, U.S. District Court, Southern District of New York (Manhattan).

88. David Glovin, Bob Van Voris & Joshua Gallu "Hedge Fund Managers, Traders Charged in Galleon Trading Probe" Bloomberg, L.P, November 6, 2009.

US\$8 billion when Rajaratnam was arrested.⁸⁹ This rapid growth in fund size was the result of Rajaratnam engaging in insider trading schemes. As indicated by the SEC, Rajaratnam had cultivated a network of high-ranking corporate executives and insiders and tapped into this ring to obtain confidential details about quarterly earnings and takeover activities.⁹⁰

Prosecutors started to investigate this case in 2007 and a person working in Galloen had pleaded guilty and cooperated with the prosecutor by indicating that Rajaratnam used insider information tips to trade since 2006. Prosecutors had used telephone recordings and cell phone interception to provide evidence indicated that Rajaratnam instructed colleagues to create e-mails designed to hide his source of information and make trades to mask his illegal activities.⁹¹

Evidence indicated that Rajaratnam had traded in 2006 and 2007 on leaks from insiders at Polycom, Moody's Investors Services Inc and Market Street Partners. For example, a Moody's analysts offered news about Hilton and a Market Street Partners source provided tips about Google. Rajaratnam earned US\$12.7 million on the leaks and gave a confidential government informant inside information on other companies in return.⁹²

1. Intel

One of the six people arrested, Rajiv Goel, director in Intel Capital strategic investments, had passed news about Intel's investment in Clearwire Corp and enabled Rajaratnam to make a profit of about US\$579,000. In return, Rajaratnam placed profitable trades for the benefit of Goel in a personal brokerage account in Charles Schwab.⁹³

2. Trading Ring Scheme:

Another tipping ring involved three other defendants, Robert Moffat, Danielle Chiesi and Mark Kurland. Chiesi a Bear Stearns veteran got secret tips from her source in Akamai Technologies Inc. and from Robert Moffat who passed along information about IBM,

89. Katherine Burton & Saijel Kishan "Raj Rajaratnam Became Billionaire Demanding Edge" Bloomberg, L.P., Oct. 19, 2009.

90. David Glovin, Katherine Burton & David Scheer "Galloen's Rajaratnam Charged in Biggest Hedge Scheme" Bloomberg, L.P., Oct. 16, 2009.

91. *Ibid.*

92. *Ibid.*

93. *Ibid.*

Sun Microsystems and AMD and AMD's venture in Abu Dhabi in which IBM participated. Chiesi then passed along these tips to Kurland and both traded on the news. Also, Chiesi passed these tips to Rajaratnam, who in turn gave Chiesi inside information AMD and other companies. According to a phone conversation between Chiesi and Rajaratnam on July 24, 2008, Chiesi told Rajaratnam that her source told her that Akamai's share price would go down to US\$25. That day, Akamai share price closed at US\$32.18. As a result, Chiesi told Rajaratnam to short Akamai's shares everyday and hence Rajaratnam profited.⁹⁴

3. *The Case of McKinsey*

Anil Kumar was the director at McKinsey & Co., and he gave Rajaratnam tips about McKinsey's client. Kumar was not only a director in McKinsey, but also an investor in Galleon. He became a consultant for AMD as McKinsey's client. AMD was considering spinning off its semiconductor operation into a joint venture with the Abu Dhabi government. That would bring a major investment from an Abu Dhabi wealth fund and likely increase in AMD stock price. When both parties shook hands and sealed the deal, Kumar called Rajaratnam on August 15, 2009 to tell him to buy the stock. On that day and the following Monday, Galleon bought 5.9 million shares of AMD at between the price of US\$5.55~5.75.⁹⁵

In turn, Rajaratnam relayed the information to Chiesi of New Castle, which had purchased 199,440 AMD shares at US\$5.44. As Chiesi worried about being caught, Rajaratnam suggested covering her tracks by trading in and out of the stock while they wait for the deal's completion. On the other hand, Galleon continued to add AMD shares to its position and eventually reached 8 million shares of AMD stocks. As the deal's announcement date was October 7, Rajaratnam told Chiesi to sell half before the announcement. On October 7, AMD shares rose 25% and increased the value of Galleon's shares by US\$9.5 million. He sold 1.3 million shares on the announcement day and held the rest and watched AMD shares decline to US\$3.5 by the end of the month under a general decline of the stock market amid the global financial crisis.⁹⁶

94. U.S. v. Chiesi, 09-mag-2307, U.S. District Court, Southern District of New York (Manhattan).

95. John Helyar "Galleon Insider-Trading Case Opens Window on Secret Hedge Funds" Bloomberg, L.P., Oct. 19, 2009.

96. *Ibid.*

4. *Google*

From a source of Market Street Partners, an investor relations contractor for Google indicated that in July, 2007 that Google's second quarter earnings would be disappointing compared to market expectations later in the month. The information was relayed to Rajaratnam, who with a combination of buying Google put options and short-selling on the stock, made a US\$8 million profit.⁹⁷

5. *The Investigation*

Basically, this case is considered one of the most significant insider trading cases in the global financial world. The U.S. government's charging of Rajaratnam and five other defendants was due to the help of wiretaps as it provided rich insider details of usually secret hedge fund operations carried out by Rajaratnam and his related parties. The wire transcripts made it appear that trafficking in inside information was a routine way of business for Rajaratnam. The starting point was a 2005 job interview at Galleon which Rajaratnam asked applicants to name companies where he has an "edge" or access to inside information. The applicants had later become confidential witnesses for this case. Even though this informant was not hired by Galleon, the witness began feeding Rajaratnam inside information. The information enabled Galleon to turn a US\$4 million profit on a tip about Blackstone Group's US\$20 billion buyout of Hilton the day before the announcement. The informant in turn receives inside information from Rajaratnam on Intel and other companies. This informant later pled guilty and cooperated by taping conversations with Rajaratnam and Rajaratnam's private talks with his friends.⁹⁸

One frequent caller was Danielle Chiesi, fund manager in New Castle Partners and Bear Stearns veteran. A call in 2008 indicated, Chiesi's colleague Mark Kurland had encouraged her to get more inside intelligence from the relationships and not to worry about the consequences. As a result, Chiesi had cultivated an executive in Microchip to provide inside information and at Akamai Technologies, she had a family friend who leaked data to her. She used Akamai intelligence for New Castle's trading and passed it to Rajaratnam.⁹⁹ As indicated in a previous section, she and

97. *Ibid.*

98. *Ibid.*

99. *Ibid.*

Rajaratnam made a handsome profit by shorting the Akamai shares.

Danielle Chiesi is an important part of Rajaratnam's insider trading ring. According to the investigation, she is involved in the insider trading scheme on AMD and Akamai, she received a lot of insider information from hotel ballrooms and bars during the past decade. As an analyst at New Castle Fund LLC, a New York hedge fund that manages about US\$1 billion. She was a regular at conferences on technology companies and had face time with executives for information on their companies. She would wear short skirts and low-cut tops and barhopped to get information from people on the dance floor. A blond former teenage beauty queen, she used her sexuality to build sources at the male dominated tech companies and she was very proud of her network. As a result, Chiesi got tips from executives at technology companies and passed them to hedge fund managers such as Rajaratnam. Her boss Mark Kurland in New Castle, who was also being arrested, had encouraged her source building. The reality is Chiesi's source building paid off. New Castle made US\$3.8 million in six months, starting in July 2008 by using information gathered by her.¹⁰⁰ Please bear in mind that 2008 was the year of the global financial crisis and the equity market suffered during this period of time, so her source building did make her trade ahead of market during difficult market times.

C. Goffer – November 6, 2009

On November 6, 2009, there were additional charges on fourteen people for charges against the defendants include conspiracy and fraud. This time it focused on the center of a new insider trading ring headed by Zvi Goffer, a former Galleon employee who sought tips and Arthur Cutillo, an attorney at Ropes & Gray LLP and the ring's key source of information. As Goffer later founded his own company, Incremental Capital LLC, paid tipsters including Cutillo for information on merger and acquisitions and giving them pre-paid mobile phones so they would avoid surveillance. This new insider ring included Craig Drimal, Galleon employee; Jason Goldfarb, New York-based attorney; Goffer's brother Emauel Goffer; Atheros Communications Vice President Ali Hariri, and Incremental Capital employee David Plate; and Michael Kimelman. Another person who pled guilty and cooperated with prosecutors

100. Anthony Effinger, Katherine Burton & Ian King "Woman Who Sank Galleon Was Beauty-Queen-Turned-Analyst Insider" Bloomberg, L.P, November 22, 2009.

was Steven Fortuna, managing director at hedge fund S2 Capital. SEC also sued Schottenfeld Group, a New York-based broker dealer where several defendants worked.¹⁰¹

Within the ring, Goffer was known as “the Octopussy”, a reference to the 1983 James Bond film and indicates his reputation for having multiple sources of insider information. For example, Goffer gave one of his sources a disposable mobile phone before Bain Capital LLC’s proposed buyout of 3Com. The phone had two programmed numbers labeled “you” and “me”. After the deal was announced, Goffer removed the phone’s SIM card, bit it, and broke the phone in half.¹⁰²

As part of this ring, Arthur Cuttillo passed news about deals Ropes & Gray was working on to Jason Goldfarb, another New York lawyer, who passed the information to Goffer. Even though Cuttillo no longer worked at the firm, he got kickbacks for his tips on four deals including the purchase of Hilton Hotels Corp. Goffer passed along the tips he got from Cuttillo to Kimelman, Shankar, Plate, Drimal and his brother Emmanuel. Drimal and Shankar leaked the information to others.¹⁰³

Wiretaps provided much of the evidence similar to the in the Rajaratnam ring. As the investigator tapped Drimal’s mobile phone, Goffer’s phone calls were intercepted at Galleon as soon as he joined the company in January, 2008.¹⁰⁴

When Rajaratnam’s Galleon and Chiesi’s New Castle shorted the Akamai in 2008 Fortuna’s S2 Capital got the tips from them and shorted along with them. From this trade, Galleon made US\$3.5 million, New Castle made US\$2.4 million and S2 made US\$2.4 million. After the investigation, Fortuna pled guilty to security fraud and is cooperated with the prosecutors.¹⁰⁵

D. Gupta - March 2011

The prosecutor made public on their investigation on Rajat Kumar Gupta on April 9, 2011. Rajat Kumar Gupta was not only a board member of Goldman Sachs, but also served on Goldman

101. David Glovin, Bob Van Voris & Joshua Gallu “Hedge Fund Managers, Traders Charged in Galleon Trading Probe” Bloomberg, L.P, November 6, 2009.

102. U.S. v. Goffer

103. *Ibid.*

104. David Glovin, Bob Van Voris & Joshua Gallu “Hedge Fund Managers, Traders Charged in Galleon Trading Probe” Bloomberg, L.P, November 6, 2009.

105. Anthony Effinger, Katherine Burton & Ian King “Woman Who Sank Galleon Was Beauty-Queen-Turned-Analyst Insider” Bloomberg, L.P, November 22, 2009.

board's audit, compensation and corporate-governance committee. He was the strategic and operational expert on its board. Before joining Goldman, he was the worldwide managing director of McKinsey & Co and special adviser to Secretary General of United Nation. He also worked in AMR Group, Procter & Gamble, Harman International Industries, Genpact Ltd and Russia's OAO Sberbank after his days in McKinsey. He formed partnerships with Rajaratnam to form Taj Capital Partners in 2006 and the fund aimed to put US\$2 billion into South Asian investments and half of its investments through a hedge fund run by Rajaratnam. Even though this involvement was short lived as Rajaratnam withdrew from the deal, but this made the prosecutors investigating Rajaratnam's interest on trading in Goldman stock in 2008, especially on the trade made before the September 2008 disclosure that Berkshire Hathaway's Warren Buffett paid US\$5 billion to acquire Goldman's preferred stock paying 10% interest.¹⁰⁶

Besides Rajaratnam, Gupta had a relationship with another defendant in this case, Anil Kumar. They were friends and associates from his days in McKinsey and Kumar had pleaded guilty on January 8, 2010 for leaking insider information to Rajaratnam over 5 years and in exchange for US\$1.75 million. During Gupta's days in McKinsey, Kumar was the head of operations to outsource high-level research to India.¹⁰⁷

On the other hand, the insider trading prosecution of Gupta was built on circumstantial evidence that may be less persuasive than the wiretap evidence on Rajaratnam. As the prosecutor lacked direct wiretaps on Gupta, they sought to convict Gupta based on the timing of his phone calls with Rajaratnam and Rajaratnam's trades that immediately followed. Prosecutors unsealed a six-count indictment accusing him of leaking inside information to Rajaratnam. It began in March 2007 that Gupta tipped Rajaratnam about Goldman Sachs's first quarter 2007 earnings as he and Gupta participated in the Goldman Sachs board meeting as audit committee from Galleon's office. During the meeting, the audit committee discussed the company's quarterly earnings as it would be announced to the market the following day. This conference call had made the prosecutor to add a new securities fraud charge where there was discussion on the quarterly earnings release of Goldman

106. John Helyar, Mehul Srivastava & David Glovin "Goldman Sachs Director Gupta Dealt with Rajaratnam" Bloomberg, L.P, April 22, 2010.

107. *Ibid.*

Sachs that it would exceed analyst estimates. About 25 minutes after Gupta left the conference call; Rajaratnam's fund purchased about 350,000 Goldman shares. Gupta continued to tip Rajaratnam on its September 19, 2007 board meeting as its quarterly earnings were announced.¹⁰⁸

Gupta was also accused of telling Rajaratnam about Berkshire Hathaway's US\$5 billion investment in Goldman Sachs in September 2008, Goldman's unexpected fourth quarter loss in 2008 and P&G's poor performance in late 2008. To show Gupta tipped Rajaratnam about Berkshire's investment, evidence shows Gupta called Rajaratnam approximately 16 seconds after learning about it during Goldman Sachs board meeting on September 23, 2008 and Rajaratnam bought the shares minutes later. To establish that Gupta leaked news about Goldman's 2008 loss, he called Rajaratnam 23 seconds after leaving a board conference call on October 23, 2008 and Rajaratnam sold 150,000 Goldman shares the next morning.¹⁰⁹ To prove that Gupta disclosed P&G's poor earnings performance, the indictment cites an eight minute telephone call that Gupta made to Rajaratnam from Switzerland on January 29, 2009, hours after he learned about P&G's financial results. Rajaratnam also claimed to have gotten information from someone on the P&G board.¹¹⁰

With the prosecution on Gupta, as the prosecutor lacked direct wiretaps, the prosecutor used tools for traditional insider trading cases by matching up phone calls and trades and the timing of the meetings. In other words, they based on circumstantial evidences of well-timed phone calls and trading based on material events. Another circumstantial evidence adopted by the indictment was Gupta had invested US\$2.4 million in at least two Galleon offshore funds and put US\$10 million into a venture with Rajaratnam called Voyager Capital Partners and committed US\$22.5 million to a fund they built that focused on emerging markets in Asia.¹¹¹ In other words, a motive can be established from Gupta in providing tips for Rajaratnam as his investment with Rajaratnam could help him

108. Patricia Hurtado "Gupta Took 2007 Goldman Earnings Call at Galleon, U.S. Says" Bloomberg, L.P, Jan 31, 2012.

109. U.S. v. Gupta, 11-cr-00907, U.S. District Court for Southern District of New York (Manhattan).

110. SEC v. Gupta, 11-cv-07566, U.S. District Court for the Southern District of New York (Manhattan)

111. David Glovin, David Voreacos & Patricia Hurtado "Gupta Case Built on Circumstantial Proof May Help Defense" Bloomberg, L.P, October 27, 2011.

profit from the insider information he had access to from being the board member of Goldman Sachs and P&G.

On June 2012, Gupta was found guilty on three counts of securities fraud and one count of conspiracy with a maximum of 20 years in prison and acquitted him of two counts of securities fraud.¹¹² The prosecutor based their conviction on the argument that Gupta had illegally provided a virtual open line into the board room for his benefactor and business partner, Rajaratnam. The outcome of this case should be regarded as a victory for the office of the Manhattan U.S. Attorney and FBI in their assault on insider trading, which used tools normally employed against organized crime, including phone taps and informants. Also, Gupta is the most prominent of those convicted at trial or to plead guilty since the nationwide crackdown on insider trading in October 2009. This conviction has sent a message that no one is off the limits.¹¹³

E. Implications from These Cases

Even though the above mentioned cases are all independent cases, either the defendants had relationships or the insider trading dealing activities they engaged in were inter-related in some way. As a result, this can be illustrated as the complexity of insider trading cases. On the other hand, the prosecution of the above cases can also serve as an indication that U.S. legal authority are now more focused and stringent on insider trading activities especially amid the global financial crisis.

As a result, a few important implications emerged from the Rajaratnam and Gupta cases that will serve as valuable insight for future U.S. or China insider trading cases. They are as follows:

1. Inside information and aggressive research

The Rajaratnam's case focuses on a slice of trades that produced US\$20 million in alleged profits and provides a snapshot of network of informants and traders led by Rajaratnam. In this case, his co-conspirators included a McKinsey & Co consultant, a Intel Corp treasury manager and a Bear Stearns veteran. With the help of his insider trading ring, Rajaratnam was able to build his hedge fund to manage US\$7 billion at its peak in 2008. Even after the

112. Patricia Hurtado, David Glovin and Bob Van Voris "In Gupta, Jurors Saw the American Dream and Convicted Anyway" Bloomberg, L.P, June 16, 2012.

113. Patricia Hurtado, David Glovin & John Helyar "Rajat Gupta Convicted of Insider Trading by U.S. Jury" Bloomberg, L.P, June 15, 2012.

Internet bubble burst in 2000, Galleon's Diversified Fund climbed 43.7% in the three year period to 2002, while the S&P 500 dropped 37.3%.¹¹⁴ Before the case was discovered, Rajaratnam was considered a genius in the market, but this case proved that his profit making trades were helped by inside information. This is an issue on the violation of a perfect market. Under assumption of perfect market, every participant has equal access to information. As people like Rajaratnam exist, the market is no longer fair or perfect. Basically, the profit advantage that Rajaratnam has was due to his inside information. It is based on the disadvantage on the general investment public. This will hurt market confidence and will drastically decrease the markets competitiveness and have a detrimental effect on investment confidence.

Another significant issue about the access of inside information is the argument that it is not illegal but only considered aggressive research. As every trader wants an edge on the stocks they trade, but there are many grey areas when it comes to aggressive research. The general guideline is when you trade on material, non-public information that comes from a company insider who is breaching its fiduciary duty, and then it is considered illegal and can no longer be considered aggressive research.¹¹⁵

2. *Employees and price sensitive information*

Another important implication that arises from this case is the investigation on insider trading by Galleon Group and technology executives such as Intel and IBM may prompt Silicon Valley companies to clamp down on how employees handle sensitive financial information. These companies realize that they should make sure their employees understand the rules of insider trading on what they can and cannot talk about in regards to sensitive financial information.¹¹⁶

As for the companies who have employees or ex-employees involved in this as either being arrested or turned into witnesses such as Polycom, AMD and Intel, they all revised and reinforced their insider trading rules and policies with their employees. For Polycom, their CEO sent e-mails to all employees reminding them of the rules against divulging confidential insider information. They

114. Katherine Burton & Saijel Kishan "Raj Rajaratnam Became Billionaire Demanding Edge" Bloomberg, L.P, October 19, 2009.

115. *Ibid.*

116. Karen Gullo, Brian Womack & Ari Levy, "Rajaratnam Case Is "Wake-Up Call" for Silicon Valley Companies" Bloomberg, L.P, October 20, 2009.

also review their existing policy to see if there are further enhancements to be made. As for AMD, they consistently remind employees to manage confidential information properly. For Intel, employees who deal with material information receive training on at least an annual basis.¹¹⁷

As illustrated by these cases, many technology companies are involved with inside information as they provide a target for people to make use of insider information because their share price movements tend to be more volatile compared to other industries such as food or utilities. This fact may push the technology companies to ensure their staff and employees are familiar with policies about how to handle financial information.

3. *Issues for the hedge fund on wiretaps*

The uncovering of Bernard Madoff's US\$65 billion Ponzi scheme had increased the financial regulations for hedge funds, but this case provided a new concern for the hedge fund as they realized they may get caught on tape as the government expands use of wiretaps to ferret out insider trading. The Rajaratnam case is the first time prosecutors used secretly recorded phone conversation against hedge funds.¹¹⁸

As Rajaratnam regularly talked to hundreds of contacts, including other hedge fund traders, his arrest rattled hedge fund managers who were questioning whether legitimate discussions caught on the tapped line will draw scrutiny to their conversations. Also, a broader fear concerned the hedge fund manager as whose phones are being monitored as prosecutors and SEC continues their probes, as the word wiretap struck fear in everyone even the innocent. The hedge fund executives instructed their colleagues to be extra careful about what they say on the phone, not because they are breaking the law, but because they are fearful that any conversation about stocks could be misconstrued.¹¹⁹

On the other hand, prosecutors argue that they turned to wiretaps because of the ease hedge funds can hide when trades were based on illegal tips as it was always difficult to establish the existence of insider trading from the prosecutor's side. As illustrated in this case, Rajaratnam had instructed others to fabricate e-mail trials

117. *Ibid.*

118. Katherine Burton & David Glovin "Galleon Wiretaps Rattle Hedge Fund as Insider Trading Targeted" Bloomberg, L.P., October 26, 2009.

119. *Ibid.*

that would explain why they executed the illegal trade.¹²⁰ As a result, e-mails have become ineffective in investigating insider trading. That is the reason that prosecutor had turned to phone wiretaps to nail down important hedge fund managers such as Rajaratnam. This is because phone wiretaps provide information that is in real time and hard to manipulate by the defendant.

As wiretaps were adopted for the prosecution on Rajaratnam and his trading ring, there is a concern that wiretaps would be required for future success in prosecuting insider trading cases. The jury may expect wiretaps to be present as concrete evidence for establishing insider trading cases. On the other hand, the growing fear in wiretaps will force the hedge fund industry to improve their trading mechanism in order to pass the threat on wiretaps. As indicated by the Rajaratnam's case, trading from insider trading tips does allow a fund to make a handsome profit irregardless of the weak global financial market. As a result, the profitable incentive for insider trading does exist, so there will always be a huge temptation for hedge funds managers to continue to work on their insider information edges to get ahead from their trading peers and avoid the scrutiny of regulatory bodies such as the SEC.

4. Circumstantial evidence adopted for conviction

As for the case regarding Gupta, prosecutor adopted circumstantial evidence for his indictment. The risk for this traditional insider cases investigation is Gupta's defense may offer alternative explanations for the contacts and calls between Gupta and Rajaratnam as they are both family friends and business partners. From Gupta's defense, they claimed Gupta called Rajaratnam was to obtain information about his investment in the Voyager Fund managed by Rajaratnam.¹²¹ From the prosecutor's perspective, they believe Gupta provided the inside information to Rajaratnam because of his friendship and business relationship with Rajaratnam. On the other hand, Gupta benefited from Rajaratnam capital commitment to and position as a limited partner of the US\$22.5 million private equity fund they had.¹²²

On the other hand, Gupta was still found guilty and convicted based on circumstantial evidence as the jurors became convinced of

120. *Ibid.*

121. David Glovin, David Voreacos & Patricia Hurtado "Gupta Case Built on Circumstantial Proof May Help Defense" Bloomberg, L.P., October 27, 2011.

122. Patricia Hurtado "Gupta Took 2007 Goldman Earnings Call at Galleon, U.S. Says" Bloomberg, L.P., Jan 31, 2012.

Gupta's guilt after they examined the late-in-the-day timing of phone calls to Rajaratnam and the trades he made immediately afterwards. In other words, it was the information and actions take was the focus. The phone call records showed that Gupta called Rajaratnam just minutes before the end of trading and Galleon fund managers purchased 217,200 shares of Goldman Sachs stock just two minutes before the market closed.¹²³

As a result, the success of the conviction of Gupta based on circumstantial evidence showed the U.S. financial regulator and legal authorities decided in widening the scope on eliminating insider trading activities in the financial market. This more stringent approach will make insider trading activities more difficult to hide under the flag of coincidences, because coincidences will no longer be regarded as an effective excuse in persuading jurors that insider trading activities had not taken place.

5. *Penalty should be triple to the gain*

The federal judge ordered Rajaratnam to pay US\$92.8 million in the case brought by the SEC, this is because SEC argued that Rajaratnam's penalty in lawsuit should be triple to more than US\$94 million, an amount based on his gains and losses avoid through trades in five stocks after receiving inside information. The court ruling agreed with the SEC that Rajaratnam's crime deserved triple civil damages.¹²⁴ This is because the SEC penalties were "designed to make such unlawful trading a money losing proposition, not only just for this defendant, but for all who would consider it, by showing if you get caught, you are going to pay severely in monetary terms".¹²⁵

In another words, the US regulators had inclined towards severe penalties to discourage insider trading from taking place in the first place. This is because regardless of using wiretaps or circumstantial evidence, insider trading is difficult and timely to catch in the first place. If a penalty can serve as an effective tool to decrease chances of insider trading taking place, this should be considered an effective approach for limiting and decreasing the harm that insider trading imposes on the general financial market.

123. Patricia Hurtado, David Glovin and Bob Van Voris "In Gupta, Jurors Saw the American Dream and Convicted Anyway" Bloomberg, L.P, June 16, 2012.

124. Patricia Hurtado "Rajaratnam Must Pay \$92.8 million in SEC Case, Judge Rules" Bloomberg, L.P, November 8, 2011.

125. SEC v. Rajaratnam, 09-cv-8811, U.S. District Court, Southern District of New York (Manhattan).

6. *Hedge fund lawsuit risk rises as insurance companies are quoting coverage*

Since the hedge fund risk of lawsuit is rising after regulatory probes of insider trading at Galleon Group, insurers are quoting rates that are 5 to 10% higher for coverage that protect hedge funds against government investigations and investor lawsuits, after two years of rate declines. A hedge fund with US\$200 million in assets under management seeking US\$5 million of coverage could pay about US\$75,000, up from less than US\$70,000 six months ago.¹²⁶

This type of professional liability coverage pays a hedge fund's legal expenses if employees are the subject of a regulatory probe or legal action by government or investors. The policies are triggered once allegations are made, and before fault has been determined. On the other hand, insurers can deny or try to claw back claims payments if policy terms are violated. In practice, most hedge funds allocate the costs of coverage to investors.¹²⁷

In regards to this type of insurance policies, it is still the investors paying for the cost of the fund manager's wrong doing. Once the policies are triggered by a regulatory probe or legal action by government or investors, it is the hedge fund being paid by the insurer and it is investors who are actually paying for these policies. As a result, this type of insurance policy is actually a way to protect hedge fund managers in doing insider trading. Once they are investigated by the regulator, they can still get coverage from the insurer at the expense of investors. As a result, this is an indication on how Wall Street and financial professionals are able to use advance financial mechanisms to protect themselves against investigations and investor claims. In other words, the government regulators should also look into this type of insurance coverage to prevent hedge fund managers from hedging away all their risks toward regulators and investors.

IX. CONCLUSION

In general, the issues for China's insider trading situation examined alone or compared with the U.S. could be concluded as follows.

In recent years as insider trading cases have grown exponentially in China, Chinese regulators have recognized their need to

126. Noah Buhayar "Hedge Funds Lawsuit Risk Rises After Galleon Probe" Bloomberg, L.P., March 14, 2012.

127. Ibid.

improve their regulations in regulating the securities market and restrict the occurrence of insider trading. As a result, they introduced several new measures and rules in recent years in regulating the securities market. For example, they introduced Interim Provisions on the Securities Investment Advisor Business, Tentative Provisions for Issuance of Securities-related Research Reports and Interim Provisions on the Release of Securities Research Reports in 2010. In September 2011, they adopted Decision on Revising the Relevant Provisions on Major Asset Reorganization and Supporting Financing for Listed Companies, Administrative Measures for Material Assets Reorganization of Listed Companies, the Release of Suggestions on Strengthening the Supervision of Listed Companies, the Administrative Measures for the Takeover of Listed Companies, Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies, Administrative Measures for Material Assets Reorganization of Listed Companies and Regularizing the Information Disclosure of Listed Companies and Behaviors of Relevant Parties. Also, in May 2012, they introduced Interpretation on Several Issues Concerning the Specific Application of Law in Handling the Criminal Cases of Insider Trading and Divulgement of Insider Information. In other words, China has tried very hard to improve their insider trading regulatory system. On the other hand, as China's equity market is still a developing market, China's regulatory system is also on an ongoing improvement process.

In the past, China has been criticized that their penalties are too light in regards to crimes resulting from insider trading. As insider trading could lead to enormous profit gain, a light penalty served to be ineffective in curbing insider trading. As a result, China in recent years has also improved this aspect. They increased their penalty against insider trading. For example, the case of *Qingdao Kingking* and *Guoyuan Securities*, its two defendants are Shiao Shih Ching and Wang Yi had both sentenced death parole and Shiao with returning unlawful profit of RMB\$72.5 million. Even though a heavy penalty is not an effective mechanism in extinguishing insider trading from taking place, without it, it could make insider trading take place without a fear factor.

A. Compare China with the United States

After examining the insider trading situation in China and U.S. in recent years, we can see that the both economies are at different stages of developing their insider trading regulatory mechanism.

1. U.S. Perspective

Since the U.S. equity market is a very mature market with a long history in addressing insider trading, for example its related regulations were introduced as early as 1920s, its problem leading to recent insider trading is a people issue. Despite its comprehensive regulatory mechanism, people's greed and desire for more than normal profit has led to insider trading to occur in recent years. Rajarnanrun and Gupta are both financial elites controlling both a popular fund house (Galleon) and a major U.S. financial institution (Goldman Sachs), but their positions did not hinder them from engaging in insider trading. In other words, it's the human issue in insider trading that will be the most difficult to address. This is also the reason why U.S. regulators engaged in a method that usually deals with drug dealers or criminals in investigating insider trading in the cases above. This is because insider trading in a sense is as harmful as a drug problem. Insider trading is the drug problem in the financial market.

2. China's Perspective

In China's case, it is still at the stage of needing more comprehensive insider trading regulations in targeting its insider trading dealing resulted from shell listing or amphibian officers. Once China improves their insider trading regulatory framework, then they will gradually have to address the human issue in insider trading just as the United States is today. They may also have to acknowledge insider trading is as harmful to its financial market as a drug problem is to human beings. At that stage, they may also have to broaden their evidence collection mechanism to insider trading such as wiretaps or circumstantial evidence as is the case with the Unites States in recent years.

GLOSSARY

Selected Chinese Names and Terms

Law

Company Law	公司法
Securities Law	证券法

Interim Provision

(Note: Interim Provisions issued by the relevant governmental departments are just as good as law in China.)

Administrative Measures for Material Assets Reorganization of Listed Companies	上市公司重大资产重组管理办法
Interim Provisions on the Securities Investment Advisor Business	证券投资顾问业务暂行规定
Listing Rules	股票上市规则
Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies	上市公司股东持股变动信息披露管理办法
Opinions on the Application of Securities and Futures Laws	首次公开发行股票并上市管理办法
Regularizing the Information Disclosure of Listed Companies and Behaviors of Relevant Parties	关于规范上市公司信息披露和相关各方行为的通知
Tentative Provisions for Issuance of Securities-related Research Reports	发布证券研究报告暂行规定
The Administrative Measures for the Takeover of Listed Companies	上市公司收购管理办法

- | | |
|--|----------------------------------|
| The Decision on Revising the Relevant Provisions on Major Asset Reorganization and Supporting Financing for Listed Companies | 关于修改上市公司重大资产重组与配套融资相关规定的决定 |
| The Interpretation on Several Issues Concerning the Specific Application of Law in Handling the Criminal Cases of Insider Trading and Divulgement of Insider Information | 关于办理内幕交易、泄露内幕信息刑事案件具体应用法律若干问题的解释 |
| The Notification on the Regulation on Major Purchase or Selling of Large Assets buy Listed Companies | 关于规范上市公司重大购买或出售资产行为的通知 |
| The Paper in relation to exam and approval domestic enterprise issuing stock in overseas market | 关于境内企业到境外发行股票和上市审批程序的函 |
| The Release of Suggestions on Strengthening the Supervision of Listed Companies | 加强上市公司监管工作意见 |

Court

- | | |
|--|---------------|
| Beijing Higher People's Court | 北京市高级人民法院 |
| Beijing Second Intermediate People's Court | 北京市第二中级人民法院 |
| Henan Province People's High Court | 河南省高级法院 |
| Supreme People's Court of the People's Republic of China | 中华人民共和国最高人民法院 |

Government Organization

- | | |
|---|-------------|
| China Securities Regulatory Commission (CSRC) | 中国证券监督管理委员会 |
|---|-------------|

Development and Reform Commission	发展与改革委员会
State Council Securities Commission	国务院证券委员会
The Ministry of Commerce of the People's Republic of China (MOFCOM)	中华人民共和国商务部
Company	
Beijing Centergate Technologies Co. Ltd	北京中关村科技发展控股股份有限公司
Beijing Eagle	北京鹏润投资有限公司, 北京鹏润
Beijing Heng Yi Xiang Business Consulting Company Limited (Heng Yi Xiang)	北京恒益祥商业咨询有限公司
Beijing Huaer Company Limited	北京化二股份有限公司
Beijing Pengtai	北京鹏泰投资有限公司, 北京鹏泰
Beijing Pengrun Property Development Holding Company Limited	北京鹏润地产控股有限公司, 鹏润地产
Cheung Kong (Holdings) Limited	长江实业(集团)有限公司
China Eagle	中国鹏润集团有限公司, 中国鹏润
China Galaxy Securities	中国银河证券股份有限公司
China International Trust and Investment Corporation (Citic Group)	中国国际信托投资公司

China Petrochemical Corporation (Sinopec)	中国石油化工集团公司
CITIC Group	中国中信集团公司
Ever bright Securities Company Limited	光大证券股份有限公司
Gome Electrical Appliances Holdings Ltd	国美电器控股有限公司
Guoyuan Securities	国元证券股份有限公司
Hunan Jiuzhitang Co, Ltd	湖南九芝堂股份有限公司
Jinghua Automation Group	京华自动化集团有限公司, 京华自动化
Qingdao Kingking	青岛金王集团
Qingdao Kingking Applied Chemistry Co.,Ltd	青岛金王应用化学股份有限公司
Sanlian Commercial Corporation	三联商社股份有限公司
Shandong Longjidao	山东龙脊岛建设有限公司
Shenzhen Sheng Feng Yuan Industry Company Limited (Sheng Feng Yuan)	深圳市盛丰源实业有限公司
Shogang Group	首都钢铁集团有限公司
ST Jintai	山东金泰集团股份有限公司
Shougang Concord International Enterprises Company Limited	首长国际企业有限公司
Taifu Development Co Ltd	泰富发展有限公司
Tianching Ying Shun	天津市盈顺商贸有限公司

Tung Wing Steel Holdings Limited	东荣钢铁集团有限公司
Yongle	永乐（中国）电器销售有限公司，中国永乐

People's Name

CAO Chujian	曹楚娟
CHEN Sou Bing	陈索斌
CHOU Hong Ching	周宏清
DENG Zhan	邓湛
DU Juan	杜鹃
GUO Jingyi	郭京毅
HUANG Guangyu	黄光裕
LIN Jiafeng	林家锋
SHIAO Shih Ching	肖时庆
WANG Lai	王磊
WANG Wei	王薇
WANG Yi	王益
XIANG Huaizhu	相怀珠
XU Zhongmin	许钟民
ZHENG Xiaowei	郑晓微

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