MISAPPROPRIATION THEORY: HOW THE WORLD'S TWO LARGEST ECONOMIES REGULATE INSIDER TRADING

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I. INTRODUCTION

Prior to the government adopting policies of economic reform in the late 1970s, the People's Republic of China ("the PRC" or "China") did not

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have a formal securities market or an accompanying regulatory scheme. For the most part, it was not operationally feasible for a market to develop and flourish in China because the PRC had a centrally planned economy with state-owned enterprises as the primary form of business ownership.[1] However, economic reform brokered conditions where stock trades casually began in markets located in Shanghai, Shenzhen, Chengdu and several other cities in the early 1980s.[2] This informal trading persisted until the formal establishment of modern stock exchanges in Shanghai and Shenzhen in December 1990.[3]

Historically, the securities market in China has been prone to fraud and corruption. In fact, there have been occasions where Chinese officials have been openly involved in the fraud and corruption that has taken place.[4] To address these issues in its securities market, Chinese regulators sought assistance from abroad. Specifically, in April of 1994, China's securities regulatory authority, the China Securities Regulatory Commission ("CSRC"), signed a Memorandum of Understanding with the United States Securities and Exchange Commission ("SEC") in a move designed to obtain access to technical and enforcement assistance from its American counterpart.[5] Pursuant to the guidance it received under the Memorandum of Understanding ("1994 MOU"), China implemented many of the policies used by the SEC in its securities regulation efforts. One example of such implementation was China's revamping of its regulatory configuration from two independent levels (the CSRC and the Securities Commission of the State Council or "SCSC") to a single-level structure in which the CSRC is subordinate to the SCSC.[6] Another example is the *Securities Law of the People's Republic of China* ("1998 Securities Law"), which implements many securities laws that are also used in America.[7]

China is the world's second-largest economy in terms of nominal gross domestic product (GDP) and has the fourth-largest stock exchange in the world in terms of market capitalization. The United States is the largest economy in the world in terms of nominal GDP with the two largest stock

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[1] ZHU SANZHU, SECURITIES REGULATION IN CHINA 4 (1st ed. 2001).

[2] STEPHEN GREEN, CHINA'S STOCKMARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 9 (1st ed. 2003).

[3] *Id.* at 11-12 ("Setting up the stock exchanges, 1989-90").

[4] *Id.* at 14 ("The crowds suspected, correctly as it transpired, that most [5m IPO application forms] had been sold on the black market or stolen by police, bank staff and the other government officials involved in the sale") (clarification added).

[5] *SEC and CSRC Announce Terms of Reference for Enhanced Dialogue*, UNITED STATES SECURITIES AND EXCHANGE COMMISSION (May 2, 2006), https://www.sec.gov/news/press/2006/2006-63.htm.

[6] *About CSRC,* CHINESE SECURITIES REGULATORY COMMISSION, http://www.csrc.gov.cn/pub/csrc_en/about/.

[7] Securities Law of the People's Republic of China, art. 74(5) (1998) Zhongguo min shi fa lš fa gui,

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exchanges in the world in terms of market capitalization. Because of these facts and China's obtainment of significant technical and enforcement assistance from the United States in the area of securities law, this paper will address the issue of misappropriation of inside information from a comparative perspective by discussing the issue under both Chinese and American securities laws.[8] After a general introduction to insider trading theories in Part I of this paper, Part II will discuss the American approach to regulating misappropriation and Part III will discuss China's basic approach to the issue. Part IV will consider and answer the question of whether a breach of fiduciary duty requirement is the proper approach for regulating misappropriation or whether applying misappropriation liability without a fiduciary duty requirement is the better approach. Part V will provide suggested solutions for addressing the problems with both the American and Chinese approaches to regulating misappropriation.

A. Legal Versus Illegal Insider Trading

"Insider trading" is a term that suggests the illegal buying or selling of securities. However, insider trading can be both legal and illegal.[9] Essentially, insider trading is where a corporate insider buys or sells stock in his or her own company.[10] A "corporate insider" is a member of a company's board of directors, a corporate officer, or any beneficial owner with more than ten percent ownership of equity securities registered with the SEC.[11] Legal insider trading is the buying or selling of securities by corporate insiders without the use of material nonpublic information about the security. When corporate insiders trade on their company's securities, they must report the trades to the SEC.[12] Illegal insider trading is the unlawful buying or selling of a company's securities based on material nonpublic information about the security (hereinafter referred to simply as "insider trading").[13]

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[8] *The World's Top 10 Largest Economies,* FOCUSECONOMICS: ECONOMIC FORECASTS FROM THE WORLD'S LEADING ECONOMISTS (November 8, 2018), https://www.focus-economics.com/blog/the-largest-economies-in-the-world; *see also* Vikas Shulka, *Top 10 Largest Stock Exchanges in the World by Market Capitalization,* VALUE WALK (February 19, 2019), https://www.valuewalk.com/2019/02/top-10-largest-stock-exchanges/, which lists the New York Stock Exchange (United States) at $22.9 trillion, NASDAQ (United States) at $10.8 trillion and Shanghai Stock Exchange (China) at $4.02 trillion, making them 3 of the top 4 exchanges in the world.

[9] United States Securities and Exchange Commission, *Insider Trading* (2019), https://www.investor.gov/additional-resources/general-resources/glossary/insider-trading.

[10] *Id.*

[11] United States Securities and Exchange Commission, *Forms 3, 4, 5* (2013), https://www.sec.gov/fast-answers/answersform345htm.html.

[12] 15 U.S.C. § 78p (1934).

[13] United States Securities and Exchange Commission, *supra* note 9.

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B. Current Legal Theories of Insider Trading in the United States

Currently, there are two basic legal theories used to apply insider trading liability: (1) the classical theory and (2) the misappropriation theory. Under the classical theory, a corporate insider trades the shares of his or her company, in violation of a fiduciary duty, using material nonpublic information obtained in the course of performing his or her duties on behalf of the corporation.[14] The corporate insider is considered a fiduciary, i.e., a person "who owes to another the duties of good faith, trust, confidence, and candor," because of the position that he or she holds within the corporation.[15]

Under the misappropriation theory, a fiduciary who is not a corporate insider trades on material nonpublic information obtained by virtue of his or her relationship with the company.[16] Misappropriation theory also encompasses cases where the corporate insider does not personally trade on material nonpublic information, but passes the information on to another party that does trade on it; here, the test for liability is based on whether the corporate insider will personally benefit from the disclosure.[17] Furthermore, misappropriation theory includes cases where a non-fiduciary misappropriates material nonpublic information, in violation of a duty of trust and confidence, by passing the information on to another party who subsequently trades based on the information.[18]

C. Arguments for Legalizing Insider Trading

Some believe that it should not be illegal for an insider to trade based on material nonpublic information. For example, noted economist Milton Friedman argues against insider trading based on the concept of market efficiency.[19] Friedman asserts that the market pressures of buying and selling will punish corporate wrongdoers.[20] As support for his theory, Friedman contends that trading on material nonpublic information should not be illegal because, by allowing insider trading, it gives potential whistleblowers an

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[14] Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225 (2017)

[15] Fiduciary, BLACK'S LAW DICTIONARY (10th ed. 2014); *see also* Chiarella v. United States, 445 U.S. 222, 232-33, 235 (1980).

[16] United States v. O'Hagan, 521 U.S. 642 (1997).

[17] Dirks v. SEC, 463 U.S. 646, 662 (1983).

[18] *O'Hagan*, 521 U.S. at 652-53 ("the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of duty owed not to the trading party, but to the source of the information"); United States v. Falcone, 257 F.3d 226 (2d. Cir. 2001).

[19] Josh_B, *Milton Friedman on Insider trading*, ELITETRADER (March 12, 2003), https://www.elitetrader.com/et/threads/milton-friedman-on-insider-trading.14996/.

[20] *Id.*

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incentive to disclose.[21] Friedman argues that, under the current regulatory system, potential whistleblowers take a chance by disclosing wrongdoing with nothing to gain for their efforts.[22] The whistleblowers gain from trading on inside information and punish corporate wrongdoers at the same time by driving down the share price through the selling of their shares in the company.[23]

Friedman further argues that insider trading rewards good corporate citizens by allowing them to purchase stock based on the inside information; this also serves as a signal to the market that the corporation is doing well and helps to raise the share price because other investors will see the purchase volume and follow suit.[24] Mr. Ajay Shah, a former professor at the Indira Gandhi Institute of Development Research in Mumbai, India, also supports the market efficiency model.[25]

Henry Manne makes four basic arguments for legalizing insider trading.[26] His first argument is that insider trading cannot truly be stopped, as evidenced by the fact that the SEC does not win many insider trading cases that it brings; this is most likely why the SEC did not pursue insider trading charges against Martha Stewart.[27] Manne's second argument is that insider trading helps to accurately price shares; this is comparable to Friedman's whistleblower argument. The base of this argument is that trading drives share prices up when informed people trade on good news, while trading drives share prices down when they trade on bad news.[28] Manne claims that corporate scandals such as Enron and Global Crossing would not have occurred if insider trading were legal because the insiders who knew of the problems in the companies would have used their inside information to trade and get rich, thus signaling to other investors that there were problems in those companies.[29] Manne's third argument is that the use of inside information would serve as a form of incentive compensation for

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[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] Ajay Shah, *Why forbid insider trading?* (March 25, 1998), http://www.mayin.org/ajayshah/MEDIA/1998/insider.html.
[26] *See* Henry Manne, *The Case for Insider Trading,* WALL ST. J. (March 17, 2003), https://www.wsj.com/articles/SB104786934891514900; *see also* Henry Manne*, Insider Trading and Property Rights in New Information,* 4 CATO J. 3 (1985), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.134.401&rep=rep1&type=pdf; Joel Roberts, *Prosecuting Martha*, CBS NEWS (June 24, 2003), https://www.cbsnews.com/news/prosecuting-martha/; and Larry Elder, *Legalize Insider Trading*, CAPITAL MAGAZINE (September 24, 2004), https://www.capitalismmagazine.com/2004/09/legalize-insider-trading/ (interview with Henry Manne).
[27] *See* Elder, *supra* note 26.
[28] *Id.*
[29] *Id.*

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entrepreneurial officers and employees in large corporations who are creative and take risks on behalf of the company.[30] Finally, Manne argues that insider trading, on a worldwide scale, is effectively legal because no regulatory authority truly enforces its country's laws against such trading; Manne declares that this is also true in the United States, but no one actually notices it because of the big headlines garnered by the SEC in cases such as Martha Stewart and ImClone.[31]

Opponents of insider trading regulation point to the fact that Great Britain did not enact insider trading regulations until 1980.[32] Opponents also note that Japan did not ban insider trading until 1988 and evidence suggests the ban did not give investors the reassurance the government thought it would. In fact, Ramseyer suggests that the ban may have played a role in the Japanese stock market collapse that occurred after the market closed at 611 trillion yen in 1989.[33] Ramseyer states that no one has been able to identify the precise cause of the stock market collapse, but that given the prosperity of the rest of the Japanese economy, the factor that stands out is the insider trading ban. Ramseyer also says that the Japanese stock market still has not recovered.[34]

D. ARGUMENTS AGAINST LEGALIZING INSIDER TRADING

Alan Palmiter provides three theories for regulating insider trading.[35] First, insider trading is unfair to traders who lack access to the same information available to insiders and others.[36] Palmiter indicates that the legislative history of the Securities Exchange Act of 1934 ("1934 Act") is full of congressional trepidation regarding unfairness and abuse in trading based on inside information.[37] Second, insider trading undermines the integrity of stock trading markets, making investors leery of putting their money into a market in which they can be exploited.[38] Palmiter maintains that a fair and informed securities trading market, the purpose for enacting

[30] *Id.*
[31] *Id.*
[32] Barbara Ann Banoff, *The Regulation of Insider Trading in the United States, United Kingdom, and Japan*, 9 MICH. J. INT'L L. 145 (1988), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1754&context=mjil.
[33] J. Mark Ramseyer, *Insider Trading in Japan*, The Harvard John M. Olin Discussion Paper Series (August 2011), https://dash.harvard.edu/bitstream/handle/1/30011623/Ramseyer_705.pdf?sequence=1.
[34] *Id.*
[35] ALAN R. PALMITER, SECURITIES REGULATION: EXAMPLES AND EXPLANATIONS (2nd ed. 2002).
[36] *Id.* at 316-17.
[37] *Id.* at 317.
[38] *Id.*

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the 1934 Act, is essential to raising capital.[39] He elaborates that insider trading may increase the spread between the bid and ask prices because market intermediaries, such as specialists on the stock exchanges, may fear victimization by corporate insiders.[40] Palmiter states that greater spreads increase trading costs and undermine market confidence.[41] Third, insider trading exploits confidential information of great value to its holder, which Palmiter calls a "business property rationale."[42] He points out a "property rationale makes sense" because "those who trade on confidential information reap profits without paying for it and undermine incentives to engage in commercial activities that depend on confidentiality."[43]

Utpal Bhattacharya and Hazem Daouk of the Kelley School of Business at Indiana University in Bloomington, Indiana present an interesting argument against legalization of insider trading.[44] Bhattacharya and Daouk studied insider trading laws in 103 countries with stock markets and found that only 87 of them had insider trading laws.[45] Furthermore, they discovered that only 38 of the 87 countries with insider trading laws had prosecuted insider trading violations.[46] Bhattacharya and Daouk concluded that enforcement of insider trading laws typically reduces the cost of equity by about 5% (after controlling for risk, liquidity and shareholders' rights).[47]

Proponents of insider trading regulation also point out that the benefits of such regulation are seen in the fact that about half of American households now have members that own equities directly or indirectly through mutual funds and pension plans.[48] These proponents further argue that insider trading is dangerous because the profit potential from a drop in security prices can promote behavior detrimental to the best interests of the insider's company; thus, the best interests of corporations are served by regulating the practice.[49]

II. AMERICAN REGULATING OF MISAPPROPRIATION

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[39] *Id.*
[40] *Id.*
[41] PALMITER, *supra* note 35.
[42] *Id.*
[43] *Id.*
[44] Utpal Bhattacharya and Hazem Daouk, *The World Price of Insider Trading*, 57 J. OF FINANCE 1 (2002), https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2005/BD_The_world.pdf.
[45] *Id.* at 2.
[46] *Id.*
[47] *Id.* at Abstract.
[48] Michael Sheetz, *More Americans than ever own stocks, potentially giving the market a bigger wealth effect,* CNBC (January 16, 2019), https://www.cnbc.com/2019/01/16/more-americans-than-ever-own-stocks-potentially-giving-the-market-a-bigger-wealth-effect.html.
[49] Saul Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUBLIC POL'Y 101 (1988).

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American regulation of insider trading activities in its securities market begins with the 1934 Act, which prohibits the use of any "manipulative or deceptive device or contrivance" in connection with securities trading.[50] Pursuant to the 1934 Act, the SEC uses its regulatory authority to promulgate Rule 10b-5, which states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[51]

The federal courts have used Rule 10b-5 to impose duties of confidentiality and disclosure on those in possession of inside information. These duties embrace the notion of a fiduciary obligation to corporate shareholders in order to incur insider trading liability. Despite its use by the courts, Rule 10b-5 does not refer to the concept of a "corporate insider." Rather, the corporate insider concept has been developed via case law. For example, in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961), the seminal case that introduced the SEC's concept of a corporate insider, the SEC asserted that corporate insiders, especially officers, directors and controlling shareholders of a company, possess a duty to disclose in cases dealing with securities. Subsequently, in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d. Cir. 1968), *cert. dismissed*, 394 U.S. 976 (1969), the Second Circuit of the United States Court of Appeals imposed an absolute duty to abstain or disclose on those with possession of "material inside information."

In *Chiarella v. United States*, 445 U.S. 222, 232-233, 235 (1980), the United States Supreme Court modified the absolute rule set forth by *Texas Gulf Sulphur*. The Supreme Court in *Chiarella* opted to impose a duty of confidentiality based on a fiduciary duty or other relationship of trust and confidence.[52] It accepted the two elements set out in *Cady Roberts* for establishing a violation of Rule 10b-5: (1) the presence of a relationship

[50] 15 U.S.C. § 78j. (1934).
[51] 17 C.F.R. § 240.10b-5. (1934).
[52] *Chiarella*, 445 U.S. at 232-33, 235.

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providing access to inside information intended only for corporate use, and (2) the unfairness of allowing corporate insiders to use the information without disclosure.[53] The High Court, in *Dirks v. SEC*, 463 U.S. 646, 662 (1983), specifically addressed the issue of tipper/tippee liability in cases involving whistleblowers who pass confidential corporate information to third parties for reasons other than personal gain. The Court held that tippers were under no duty to abstain from using inside information when their motivation was a desire to expose fraud.[54] The Court indicated that liability is proper when the tipper is motivated by a desire to obtain personal gain.[55] Similarly, in *United States v. O'Hagan*, 521 U.S. 642 (1997), the U.S. Supreme Court extended the *Chiarella/Dirks* duties to situations involving misappropriation of inside information to outsiders. This culminated in *United States v. Falcone*, 257 F.3d 226 (2d. Cir. 2001), wherein the United States Court of Appeals for the Second Circuit ("2nd Circuit") expanded the misappropriation theory to include cases where the inside information traveled through multiple layers of parties before becoming available to the tipper and subsequently provided to the tippee.

A. Duty of Confidentiality from the Chiarella v. United States Case

The man in question, Mr. Chiarella, was employed as a markup man in the composing room of a financial printer that was hired by corporate raiders to print five announcements of corporate takeover bids. However, when Mr. Chiarella was able to figure out the identities of certain targeted corporations, he opted to buy stock in the targets without disclosing his knowledge. Mr. Chiarella then sold the shares immediately after the takeover attempts became public knowledge. Mr. Chiarella realized a gain of more than $30,000 over a fourteen-month period before the SEC began to investigate his trading activities. The SEC investigation resulted in Mr. Chiarella signing a consent decree in which he agreed to return his profits to the sellers of the shares. Despite the consent decree, the federal government indicted Mr. Chiarella on 17 counts of violating Section 10(b) of the 1934 Act and SEC Rule 10b-5.

At trial, Mr. Chiarella was convicted on all 17 counts —a conviction later affirmed by the 2nd Circuit. The U.S. Supreme Court granted certiorari and held that Mr. Chiarella could not be convicted on the theory of failure to disclose his knowledge to shareholders of the

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[53] *Id.* at 227.
[54] *Dirks*, 463 U.S. at 666-67.
[55] *Id.*

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target corporations (or to the target corporations themselves) because he did not have a duty to disclose to either the shareholders or the target corporations.[56] The Court determined that Mr. Chiarella was not an agent or fiduciary of the shareholders or the target corporations and was not a person in whom they had placed their trust and confidence, but was rather a person who dealt with them only through impersonal market transactions.[57] The Court further held that the Section 10(b) duty to disclose does not arise from simply possessing nonpublic market information.[58] Thus, Mr. Chiarella's convictions were overturned.[59]

B. Tipper/Tippee Liability Under SEC v. Dirks

Mr. Dirks was a securities analyst who focused on the insurance industry. One day, Mr. Secrist, a former insurance company officer, told Mr. Dirks about his former insurance employer's massive fraud and imminent financial collapse. Mr. Dirks passed the information along to his firm's clients, who sold their holdings in the insurance company before the fraud scandal became public news. The SEC investigated Mr. Dirks and found him in violation of Rule 10b-5 because he tipped his clients about confidential information.

The case wound up in the U.S. Supreme Court, which held that Mr. Dirks did not violate Rule 10b-5 because Mr. Secrist's reasons for revealing the scandal to Mr. Dirks were not to obtain personal benefit. The Court did indicate, however, that Mr. Secrist's tip to Mr. Dirks would have violated Rule 10b-5 if Secrist had breached a fiduciary duty. The Court stated that a breach of duty occurs when an insider gains some direct or indirect personal benefit or accrues some reputational gain that can be used for some later benefit. In the *Dirks* case, Mr. Secrist, the tipper, exposed the fraud going on at the insurance company without any expectation of personal gain; thus, he did not breach any fiduciary duty. Since Mr. Dirks, as the tippee, would derive a duty to disclose or abstain only if the tipper possessed the duty, he also could not be liable for passing the information to his clients. As Justice Powell stated in the majority opinion, "a tippee assumes a fiduciary duty to shareholders of a corporation not to trade on material nonpublic information *only* when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know

[56] *Chiarella*, 445 U.S. at 229-233.
[57] *Id.* at 232-33.
[58] *Id.* at 235.
[59] *Id.* at 225.

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that there has been a breach."[60] Again, the key concept is that tippee liability derives from tipper liability incurred by a breach of fiduciary duty on the part of the tipper.

The U.S. Supreme Court reaffirmed the *Dirks* personal benefit test for tippee liability (i.e., tippees being traders acting on disclosures of material nonpublic information made by insiders) in its recent decision in Salman v. United States.61

C. *MISAPPROPRIATION THEORY UNDER UNITED STATES V. O'HAGAN*

In the *O'Hagan* case, Mr. O'Hagan was a partner in a law firm that was hired by a bidder planning to make a tender offer to shareholders of a target corporation. The client-bidder was a third party. Mr. O'Hagan used the information he gained in his firm's representation of this third-party bidder to purchase common stock and call options in the target corporation and sell them for a large profit of about $4,300,000. The SEC investigated Mr. O'Hagan's trades and referred the matter to the U.S. Department of Justice ("Justice Department") for criminal prosecution.

The Justice Department indicted Mr. O'Hagan for securities fraud, mail fraud and money laundering. Mr. O'Hagan was convicted on all the counts and received a prison sentence. Mr. O'Hagan appealed his conviction to the United States Court of Appeals for the Eighth Circuit ("8th Circuit"), which reversed his conviction on the grounds that misappropriation of inside information did not violate Rule 10b-5. The U.S. Supreme Court reversed the 8th Circuit decision, concluding that the unauthorized use of inside information constitutes the use of a deceptive device in connection with securities trading as prohibited by Rule 10b-5. Specifically, the Court stated that "a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of duty owed to the source of the information."[62] The

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[60] *Dirks*, 463 U.S. at 660 (emphasis added) (at pages 666-67, Justice Powell went on to state: "It is clear that neither Secrist nor the other Equity Funding [insurance company] employees violated their Cady, Roberts duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks" (clarification added)).

[61] Salman v. United States, 137 U.S. 420, 423, 429 (2016).

[62] *O'Hagan*, 521 U.S. at 652 (at page 653, the Court stated "We agree with the Government that misappropriation, as just defined [on page 652], satisfies § 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities." (clarification added)).

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Court indicated that a fiduciary "deal[s] in deception" when he or she "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain."[63]

Justice Thomas, in a separate opinion where he concurred in part, dissented in part and was joined by Chief Justice Rehnquist, agreed that "undisclosed misappropriation can be a fraud on the source of the information" and stated that a case where someone fraudulently appropriates information for his or her own use "constitutes embezzlement, regardless of what the embezzler chooses to do with the money."[64]

In short, the High Court gave federal prosecutors the ability to use the misappropriation theory to prosecute individuals who have traded on material, non-public information, even if they did not work for the corporation whose stock was traded, if the individuals otherwise owed a fiduciary duty to the company's shareholders.

D. Expansion of Misappropriation Liability in U.S. v. Falcone

In the *Falcone* case, Business Week magazine published an ongoing column called "Inside Wall Street," which critiqued the financial prospects for various companies listed on Wall Street. Business Week attempted to maintain the column's secrecy prior to its publication in order to avoid any effect on securities prices. However, several parties acquired the column prior to its publication because of their respective roles in the magazine's production and distribution process. The graphics company transmitted the magazine containing "Inside Wall Street" to three separate printers, one of which sent the magazine to a circulation company, which in turn sent the magazine to the wholesalers. All parties with access to the critiques prior to publication were aware of the security measures in place to protect the secrecy of the critiques. A manager for the wholesaler had an agreement with a stockbroker to provide the stockbroker with copies of "Inside Wall Street" critiques prior to their becoming available to the general public. The manager received $200 for each critique that he gave to the stockbroker, and the manager paid a subordinate $20 for each critique the subordinate faxed to the stockbroker. The manager eventually brought Mr. Falcone into the enterprise by providing the critiques to Falcone for $200 each. Mr. Falcone made nearly $4,900 in profits trading on the information contained in the critiques.

The federal government investigated Mr. Falcone's trading activities and eventually brought charges against him for insider trading using the misappropriation theory. Mr. Falcone was convicted in the District Court and

[63] *O'Hagan*, 521 U.S. at 653 (clarification added).
[64] *Id.* at 682.

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appealed his case to the 2nd Circuit. The District Court indicated that it did not believe that either Mr. Falcone or the manager had a fiduciary duty to Business Week, but that it was obligated to follow the 2nd Circuit's decision in *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), *cert. denied*, 510 U.S. 976 (1993), because of the similar facts between the two cases. The 2nd Circuit used the same reasoning it used in the *Libera* case to uphold Mr. Falcone's conviction. Specifically, the 2nd Circuit in the *Falcone* case held that the manager owed a fiduciary duty to Business Week magazine because he was aware of the security procedures the magazine had implemented in order protect the secrecy of the critiques. It also held that Mr. Falcone was aware of the manager's breach of those security procedures, making Mr. Falcone liable under Section 10(b) of the 1934 Act and Rule 10b-5. Furthermore, the 2nd Circuit determined that the *in connection with* securities trading requirement was satisfied because it was generally known that the information contained in the critiques affected securities prices.

III. CHINESE APPROACH TO REGULATING MISAPPROPRIATION

Because China has received significant technical and enforcement assistance from the SEC pursuant to the 1994 MOU, its approach to regulating fraud and corruption in the Chinese securities market is very similar to the American approach. Under American law, the two basic theories of insider trading are the *classical insider trading theory* and the *misappropriation theory*. China's securities law embraces both insider trading theories.

A. PROHIBITED TRADING ACTIVITIES IN CHINA

China's regulation of prohibited trading activities in its securities market begins with Chapter 1, Article 5 of the 1998 Securities Law, which states that fraud and "insider trading and manipulation of the securities market are prohibited."[65] Under Chapter 3, Article 43 of the 1998 Securities Law, it is illegal for employees of stock exchanges, securities companies, securities registration and clearing institutions, staff members of the CSRC and other persons prohibited by laws or administrative regulations to trade in securities while in these positions.[66] Article 45 of the 1998 Securities Law bars securities service organizations, accountants and lawyers from purchasing or selling shares from offerings in which they provided professional services to the issuer for a period of six months after the

[65] Securities Law of the People's Republic of China, art. 5.
[66] *Id.* at art. 43.

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underwriting period for such shares has expired.[67] Section 4, Article 73 of the 1998 Securities Law deals with prohibited practices by those with inside information.[68]

B. Misappropriation Theory Under the 1998 Securities Law

Under Section 4, Article 73 of the 1998 Securities Law, "any person with knowledge of inside information on securities trading or illegally obtaining such inside information shall be prohibited to take advantage of such inside information to engage in securities trading."[69] The language of Article 73 prohibits securities trading based on inside information without imposing a fiduciary relationship requirement. Article 73 mimics the two American theories of insider trading liability through its prohibition against trading by "any person with knowledge of inside information" (i.e., classical insider trading theory) and by "any other person who illegally obtained material nonpublic information" (i.e., misappropriation theory).[70] Article 74 defines *those with inside information* to include:

> [A]ny director, supervisor, and senior executive of an issuer; (2) any shareholder who holds not less than 5 percent of the shares in a company and any director, supervisor, and senior executive of such shareholder, and any actual controller of a company and any director, supervisor, and senior executive of such controller; (3) any issuer-holding company and any director, supervisor, and senior executive of such company; (4) any person who is able to obtain company information concerning the trading of its securities by virtue of the position he holds in the company; (5) any staff member of the securities regulatory authority, and any other person who administers the securities issuing and trading pursuant to his statutory duties; (6) any relevant staff member of any sponsor, securities underwriting company, stock exchange, securities registration and clearing institution and securities service organization; and (7) any other person specified by the securities regulatory authority under the State Council.[71]

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[67] *Id.* at art. 45.
[68] *Id.* at art. 73.
[69] *Id.*
[70] *Id.*
[71] Securities Law of the People's Republic of China, art. 74.

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Article 75 defines *inside information* as "the information that is not made public because, in the course of securities trading, it concerns the company's business operation or financial affairs or may have a major effect on the market price of the company's securities." Article 75 indicates that the following items constitute inside information:

> (1) the major events listed in the second paragraph of Article 67 of this Law; (2) company plans concerning distribution of dividends or increase of capital; (3) major changes in the company's equity structure; (4) major changes in security for the company's debts; (5) any single mortgage, sale or write-off of a major asset used in the business of the company that exceeds 30 percent of the said asset; (6) potential liability for major losses to be assumed in accordance with law as a result of an act committed by any of a company's directors, supervisors, or senior executives; (7) plans concerning the takeover of listed companies; and (8) other important information determined by the securities regulatory authority under the State Council to have a marked effect on the trading prices of securities.[72]

Major events alluded to in item (1) of Article 75 refers to events "that may considerably affect the price at which a listed company's shares are traded and that is not yet known to the investors."[73] Major events under Article 67 include:

> (1) a major change in the company's business guidelines or scope of business; (2) a decision made by the company concerning a major investment or major asset purchase; (3) conclusion by the company of an important contract which may have an important effect on the company's assets, liabilities, rights, interests or business results; (4) incurrence by the company of a major debt or default on an overdue major debt; (5) incurrence by the company of a major deficit or incurrence of a major loss; (6) a major change in the external conditions of the company's production or operation; (7) a change in any director, not less than one-third of supervisors or the manager of the company;

[72] *Id.* at art. 75.
[73] *Id.*

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> (8) a considerable change in the shares of the shareholders holding not less than 5 percent of the company's shares or any of the company's actual controllers, or a considerable change in the situation that they control the company; (9) a decision made by the company to reduce its capital, merge, divide, dissolve, or apply for bankruptcy; (10) major litigation involving the company, or lawful cancellation by a court of a resolution adopted by the shareholders' general meeting or the board of directors; or (11) other events specified in laws or administrative regulations.[74]

Article 76 reinforces the prohibition in Article 73 by elaborating on the specific trading activities that are banned. Article 76 states that "no person with knowledge of inside information on securities trading of a company or any other person who has illegally obtained such inside information may purchase or sell the securities of the company, divulge such information or counsel another person to purchase or sell such securities."[75] Because of the provisions in Articles 73 and 76 prohibiting trading by "any other person" with illegally obtained inside information, the 1998 Securities Law clearly accepts misappropriation as a legal theory.[76] However, due to the fact that it has no fiduciary relationship requirement, China's misappropriation theory has the potential to cover transactions that would not be covered under the American approach.

IV. FIDUCIARY DUTY VERSUS NO FIDUCIARY DUTY: WHICH APPROACH IS MORE SUITABLE?

The American approach to misappropriation theory is narrower than the Chinese approach because U.S. law requires the presence of a breach of a fiduciary duty in order to impose insider trading liability. It is true that the *Falcone* court expanded the application of misappropriation theory, but it could not extend it to eliminate the fiduciary relationship requirement because the Supreme Court had already established the requirement in *Chiarella*. Furthermore, it remains to be seen whether the other circuits will adopt the *Falcone* approach or a different method, or whether the Supreme Court will uphold the *Falcone* decision should a similar case reach the High

[74] *Id.* at art. 67.
[75] *Id.* at art. 76.
[76] *Id.* at arts. 73 and 76.

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Court. Here, the question implicated by the different approaches is which approach is better.

A. American Misappropriation Law Has a Gaping Hole

Under the *Chiarella*, *Dirks* and *O'Hagan* framework, § 10(b) of the 1934 Act and Rule 10b-5 impose a requirement to abstain from securities trading using inside information or to disclose the information, prior to trading, to the source of the information. On the other hand, China's 1998 Securities Law, under Articles 73 and 76, does not allow the disclosure option. Furthermore, China's approach does not depend on the existence of a fiduciary duty. Cases like *Falcone* demonstrate that it is not always easy to determine whether a fiduciary relationship exists, especially in cases where the party trading on the inside information is several layers removed from the original source of the information. Under the fiduciary relationship requirement, there can be no misappropriation liability without the existence of a fiduciary relationship. Therefore, if the misappropriated information is received from a non-fiduciary who does not have some other duty of trust or confidence, the party trading on the information can obtain tremendous ill-gotten profit without any fear of legal repercussions.

B. Other Problems with America's Approach to Misappropriation

As indicated above, determining the existence of a fiduciary relationship (or some other duty of trust or confidence) can be a challenge in some cases. However, there are other problems inherent in the American approach to regulation of misappropriation. A second dilemma that the American regime faces is its emphasis on the actor instead of the unfairness of the act. If a buyer gets inside information directly from a company officer or from deduction based on limited exposure to incomplete pieces of confidential information, it is still an unfair advantage to that buyer. There is no qualitative difference in the information possessed. The information is still material, nonpublic information that other buyers and sellers do not have. As the *Chiarelli* court concluded, the buyer who deduces information from limited exposure to incomplete pieces of confidential information, and who has no fiduciary relationship with the company, is not in breach of duty if he or she trades on the deduced information. The *Chiarella* court held that the buyer is not required to disclose merely because he or she possesses material nonpublic information; therefore, the other party to the transaction labors under an unfair informational disadvantage in trades with these conditions. The buyer likely would not have deduced the nature of the inside

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information if he or she was not exposed to portions of it (however small those portions were). With this gaping hole, a buyer in possession of inside information can be as deceptive as he or she desires as long as the buyer received the information indirectly in bits and pieces and deduced the rest. This is clearly a focus on the actor and not on the unfairness of the act.

A third problem with U.S. approach to misappropriation is the fact that, under the *O'Hagan* case, a tippee can escape misappropriation liability simply by informing the source of the information that he or she (i.e., the tippee) intends to trade on the inside information. It does not matter whether the tipper objects to the tippee's use of the information for securities trading purposes so long as the tippee discloses. The *O'Hagan* court held the following:

> [F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source of the information that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation-although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.[77]

The underlying problem here is that the tippee's disclosure to the source of the information may not alleviate the existence of an unfair informational disadvantage to other buyers and sellers because the source may not immediately reveal the confidential information to the general public. The source's failure to reveal would allow the tippee to engage in trades with an unfair advantage.

A fourth problem with the American approach to misappropriation is the easy circumvention of the "personal gain" test espoused by the *Dirks* court. A tipper may give a tip to a tippee without the expectation of immediate gain, thereby eluding misappropriation liability if prosecuted during the dormant period prior to realizing the personal gain. Furthermore, even if the tipper never expects to get personal gain from the tip, it does not change the fact that other buyers and sellers are at an informational disadvantage as a result of tipper's actions. Moreover, creative companies looking to get confidential information out to preferred investors can selectively give information to cooperative financial advisers who in turn can pass that information on to the designated investors. Simply put, the *Dirks* personal gain test is wrought with the potential for abuse.

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[77] *O'Hagan*, 521 U.S. at 655.

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A fifth problem with the American regime is that the goal of securities regulation is ultimately undermined by allowing a "disclose or abstain" approach. The goal of securities regulation is to provide for the fair and efficient operation of the securities market by providing fair access to market information. Securities regulation provides a framework within which the market can operate and give confidence to investors that it is functioning properly. A policy of "disclose or abstain" breeds an appearance of unfairness because the disclosure requirement suggests that the market has many buyers and sellers who are trading securities using inside information. Fairness in appearance is just as important as fairness in fact, but a "disclose or abstain" approach does not recognize this importance. The result is likely that investors who look at the market situation and conclude that it is crooked or rigged may be hesitant to participate in the market altogether. Others may go to great lengths, perhaps to great expense, to even the playing field because they believe that they must do so in order to effectively compete in the market.

C. Problems with China's Approach to the Misappropriation Theory

A problem with the Chinese approach to misappropriation is the potential for overly broad application of the theory to situations where it probably should not apply. Articles 73 and 76 of the 1998 Securities Law prohibit trading in securities where there is "knowledge of inside information" pertaining to such securities. Thus, *knowledge* is the key to triggering the Chinese approach, not whether the practice is deceptive. For example, a party that has inside information, but who does not use the inside information in conducting his or her securities trades, may be unduly caught in the vast net cast by the Chinese approach because Articles 73 and 76 do not distinguish between "knowledge of inside information" and "actual use of inside information." To elaborate on this example, suppose that on a Monday the chief executive officer ("CEO") of Hypo Company, a publicly traded corporation, directs his stockbroker to sell some of his Hypo Company stock beginning in two days. The CEO wants to acquire some cash to pay for vital medical care that his wife needs due to a serious illness. On Tuesday, the CEO receives unfavorable nonpublic material information about Hypo Company, but because of his preoccupation with his wife's medical condition, he does not cancel the stock sale. On Wednesday, the stockbroker follows the CEO's instructions per their discussion on Monday and sells the Hypo Company stock. Under Chinese law, this could theoretically result in insider trading liability because the CEO obtained negative inside information about Hypo Company prior to the execution of the trade. That

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could be the case even though the CEO's decision, on Monday, to sell the stock was not in any way based on the adverse inside information that he received on Tuesday.

Another problem with the Chinese approach to misappropriation, as well as its classical insider trading theory, is the lack of division between the public and private sectors in China. Unlike in America, where there is a clear distinction between the public and private sectors, in China there is not a clear division between the government and the operation of various businesses and companies listed on the stock exchanges. The state owns majority shares in many of the listed companies. Thus, some government officials outside the CSRC have knowledge of inside information, such as company performance, financial stability, management structure and strategic plans and operations. Yet these officials outside the CSRC are not covered by the 1998 Securities Law's definition of *those with inside information*.[78] While it is probably true that, in America, SEC officials also possess inside information about listed companies, it is generally not true that the American government owns majority shares in listed companies. Thus, it is probably not the case that American officials outside the SEC have general access to inside information about companies listed on the American stock exchanges. Therefore, the American prohibition against trading by regulatory authorities is more likely to deter overall insider trading by government officials than its Chinese counterpart.

China's lack of a broader prohibition against trading by its government officials creates a natural breeding ground for insider trading because financially ambitious government officials, with strategic information about government plans in business and elsewhere, can use their inside knowledge to make immense profits trading Chinese stocks. This puts the truly private investor at a distinct disadvantage because the business indicators may suggest one course of action by the investor while the government official with inside information knows better and acts accordingly. Additionally, Article 75 defines inside information, but it makes no mention of government information as part of the definition of inside information.[79] The omission of government officials and information from the relevant definitions of insiders and inside information basically undermines the effectiveness of Chinese misappropriation theory by allowing government officials to misappropriate. It is important that relevant government officials are covered by the prohibition against misappropriation because government plans and policies can have an enormous effect on share value and the government official in possession of that information can

[78] Securities Law of the People's Republic of China, art. 74.
[79] *Id.* at art. 75.

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unfairly use and distribute it to the disadvantage of other buyers and sellers in the Chinese securities market.

A third problem with the Chinese approach to misappropriation is the traditional lack of requisite enforcement authority on the part of the CSRC. For example, prior to 2005, the CSRC did not have the power to examine fund accounts, securities or other assets of investigation targets, nor did it have the authority to freeze assets in cases where there was risk of asset removal or hiding.[80] Furthermore, while Article 168 of the original version of the 1998 Securities Law provided CSRC investigators with the authority "to question the party concerned and any unit or individual connected with the event under investigation," it did not give investigators the power to issue subpoenas.[81] However, the 2005 amendments to the 1998 Securities Law have granted the CSRC some regulatory tools that it previously lacked. For example, under Article 180 of the 2005 amendments, the CSRC now has the authority to examine fund accounts, securities and other assets of investigation targets, and it also has the power to freeze or seal the funds or securities of investigation targets if there is risk that the targets will remove or hide the assets.[82] Additionally, Article 180 gives the CSRC the authority to confiscate assets if there is evidence to substantiate that the investigation target may conceal, forge or destroy evidence of the violation.[83] Though a very positive step towards making the CSRC a truly effective regulatory agency, the 2005 amendments still do not provide the CSRC with the power to issue subpoenas, which can be important when the CSRC needs to gain vital information that it otherwise may not be able to obtain.[84]

D. Which Approach Is More Suitable?

At first glance, it appears that the Chinese approach is more suitable because it does not require a fiduciary relationship in order to prohibit trading based on inside information. Intuitively, China's method just seems to make more sense because it evaluates the act and not the actor or actors. By judging the act, this eliminates the need to determine whether a fiduciary relationship exists. That fact is a positive one because scenarios such as the *Falcone* case and others are ever looming to make it extremely difficult to evaluate the existence of a fiduciary relationship. Rather, the Chinese approach provides a clear cut, bright-line rule: use inside information to trade and you are in violation of the country's securities law. The bright-line rule serves to promote the goals of securities regulation because it removes the need for

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[80] *Compare id*. at ch. 10, arts. 166-74 with *id.* at ch. 10, arts. 178-87.
[81] *Id.* art. 168(2).
[82] *Id.* at art. 180(6).
[83] *Id.* at art. 180(1) through (7).
[84] Securities Law of the People's Republic of China, art. 180(1) through (7).

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disclosure and projects an appearance of fairness in the operation of the market. However, the fact that Chinese securities law does not include government officials outside the CSRC as insiders is troubling because it undermines the effectiveness of the bright-line rule. The bright-line rule, while positive from a theoretical perspective, has little actual force because the very traders to whom the rule needs to apply are exempt from the rule. Therefore, America's approach, while possibly less desirable on a theoretical basis, works better in practice because it has greater potential to hold insiders accountable for violating the misappropriation rule.

V. ADDRESSING THE PROBLEMS WITH MISAPPROPRIATION THEORY

While both the American and Chinese approaches to misappropriation have their respective limitations, there are solutions to these problems. Some suggested solutions are briefly discussed below.

A. FIXING THE PROBLEMS WITH AMERICA'S MISAPPROPRIATION RULE

The problems with America's approach to regulating misappropriation can be solved successfully with appropriate action by Congress or the federal courts. One alternative is for Congress to eliminate the fiduciary relationship requirement. By removing that requirement, there would be no need to determine whether a fiduciary relationship exists, which can be a tricky prospect in some cases. It would also redirect the focus of the misappropriation analysis. In his dissent in the *Chiarella* case, Chief Justice Warren Burger suggested that § 10(b) of the 1934 Act and Rule 10b-5 supports the position that a person who possesses misappropriated inside information has an absolute duty to disclose the information or to abstain from securities trading based on the information.[85] Implementing Chief Justice Burger's position would remove the analytical focus from the actor and place it on the act where it belongs. Misappropriation is problematic because inside information has been improperly obtained *and used* to conduct securities trading, not whether someone has a relationship that causes one to deem such trading improper. By its very nature, trading on inside information places other buyers and sellers at an unfair informational disadvantage. That disadvantage is not dependent upon the nature of the relationship between the source of the information and the company about which the information pertains; thus, the preventive measure should not be dependent upon a fiduciary relationship. Implementing this measure would

[85] *Chiarella*, 445 U.S. at 240 ("I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading").

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also eliminate the need to determine whether there is personal gain under the *Dirks* test because the violation would occur as a result of the improper sharing of information, not as a result of the tipper getting a personal gain of some sort.

A great challenge to implementing Chief Justice Burger's position is the growing number of calls for legalizing insider trading. More and more commentators are arguing that free markets should be the mechanism for regulating trading behavior, and that insider trading should not be characterized as criminal behavior because it is a victimless crime, if a crime at all.[86] Added to growing arguments for legalization is the fact that the current political climate in America does not lend itself to increased securities regulation. As a general proposition, it is arguable that the factions in America that support legalization now have a greater chance of pushing existing insider trading laws in that direction because some of the current power brokers in the federal government appear to be more attuned to the idea of minimizing government regulation than was the case in previous years.[87] With the recent appointments by President Trump of conservative justices Neil Gorsuch[88] and Brett Kavanaugh[89] to the U.S. Supreme Court, it is uncertain whether the new justices will vote to maintain the current regime

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[86] *See* Milton Friedman, *supra* pp. 9-11; Elder, *supra* note 26; *See also* Brian Doherty, *Free Samuel Waksal: "Insider Trading" should not be a crime*, REASON.COM (June 25, 2002), https://reason.com/2002/06/25/free-samuel-waksal; Henry Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 3 (1985), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.134.401&rep=rep1&type=pdf; Alan Reynold, *Martha Stewart: Obstructing Justice,* CATO INSTITUTE, (June 28, 2003), https://www.cato.org/publications/commentary/martha-stewart-obstructing-injustice; Thomas Sowell, *Criminalizing Business* (April 22, 2004), https://www.capitalismmagazine.com/2004/04/criminalizing-business/ (column by noted conservative columnist); Robert McGee and Walter Block, *Information, Privilege, Opportunity and Insider Trading,* 10 N. ILL. L. REV. 1 (1989), http://www.walterblock.com/wp-content/uploads/publications/information_privilege.pdf

[87] Tim Harford, *What's so scary about insider trading*, FIN TIMES (Nov. 1, 2013), https://www.ft.com/content/6a23c7e2-40e3-11e3-ae19-00144feabdc0 (citing Milton Friedman); *see also* William Saletan, *Compassionate Corporatism,* SLATE MAG. (July 11, 2002), https://slate.com/news-and-politics/2002/07/mccain-vs-bush-on-corporate-corruption.html (Harvey Pitt, former chairman of the SEC under President George W. Bush from 2001 to 2003, said that he would make SEC oversight "kinder and gentler."); George W. Bush, *Favors Tort Reform to make it harder to sue corporations,* ON THE ISSUES, (Feb. 9, 2000), https://www.ontheissues.org/Archive/Purpose_George_W__Bush.htm; and George W. Bush, *Getting Results in Renewing America's Purpose*, ON THE ISSUES, (9 June 2000), https://www.ontheissues.org/Archive/Purpose_George_W__Bush.htm (a speech where he said: "I have set forth policies that capture my vision of government reform. They are guided by three principles: government should be citizen-centered, results-oriented, and, wherever possible, market-based").

[88] *Current Members*, SUP. CT. OF THE U. S., (2018), https://www.supremecourt.gov/about/biographies.aspx (Sworn in on April 10, 2017).

[89] *Id.* (Sworn in October 6, 2018).

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for insider trading, or whether they will advance opinions that move the current regime towards legalization. Unless political fortunes change for pro-regulation advocates, the prospects for removing the fiduciary relationship requirement will remain dim because removal represents an increase in regulation.

Notwithstanding current trends in American politics, a second alternative that Congress needs to consider is taking a page from China's 1998 Securities Law by implementing a "knowledge of inside information" approach. Under the Chinese approach, anyone who has knowledge of inside information is prohibited from trading on that information. Under Chinese law, there is no fiduciary duty or disclosure option. Implementation of the Chinese measure, tempered with a "use" provision, would make the *O'Hagan* issue of disclosure irrelevant because disclosure would not cure liability derived solely from the "use" of misappropriated information.

If lawmakers do not desire to eliminate the fiduciary relationship requirement or adopt the knowledge approach, a third alternative is for Congress or the Supreme Court to better define a fiduciary. As it currently stands, the lower courts are too inconsistent in determining who is a fiduciary and who is not. For example, in *United States v. Chestman*[90], a man whose wife gave him inside information, which he improperly shared with another party, was not held liable for misappropriation because the court determined that a marital relationship alone was not an adequate basis for applying the misappropriation theory. Conversely, the 2nd Circuit ruled that a psychiatrist violated his fiduciary duty when he traded on information that one of his patients gave him during a therapy session.[91] In these two cases, the 2nd Circuit's fiduciary analysis was inconsistent because each case had a privileged relationship from which the key actor obtained the confidential information, yet the court deemed the psychiatrist to be a fiduciary but not the husband. Congress should pass legislation that ensures, or the Supreme Court should hold in an appropriate case, that disclosing or trading on any information flowing from or through a privileged relationship would result in a breach of fiduciary duty.

B. Correcting the Problems with Chinese Misappropriation Theory

Like America, the problems with China's approach to regulating misappropriation are problems that, for the most part, can be overcome

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[90] United States v. Chestman, 704 F. Supp. 451 (S.D.N.Y. 1989), *rev'd*, 903 F.2d 75, 77-78 (2d Cir. 1990), *reh'g en banc*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

[91] United States v. Willis, 737 F. Supp. 269, 272 (S.D.N.Y. 1990), *mot. denied*, 778 F. Supp. 205 (S.D.N.Y. 1991).

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effectively if the country's central government is willing to act. First, China should develop a misappropriation test that is based on whether inside information is used. Knowledge alone is too broad of a test because, as the CEO example illustrates, it is possible for an insider to be a party to a securities trade without using inside information.

Second, China should amend its definition of *those with inside information* to include all government officials who have access to confidential information on listed companies due to, and while in, their official capacities (the 1998 Securities Law already prohibits trading by officials of the CSRC).[92] Moreover, the CSRC be given a mandate, sufficient personnel and adequate resources to vigorously go after misappropriators in official government positions. Given the current political structure of the Chinese government, it may not be easy to change the definition of an insider or to provide a mandate, sufficient personnel and adequate resources to the CSRC, but it must be done if China's securities market is ever going to reach the level of prominence enjoyed by the American securities market. The central government must be willing to regulate the activities of all government officials with inside information or the bright-line rule is meaningless and the CSRC will never truly be able to effectively regulate the country's securities market effectively.

The third step that the Chinese government should take is to give the CSRC the regulatory authority that it needs to properly investigate and enforce violations of China's securities law. This step primarily means giving the CSRC the authority to issue subpoenas, but it also means insulating the CSRC from the political influence of the State Council and members of the national communist party. Again, this must be done despite any inherent difficulties associated with China's current political structure.

Finally, the CSRC must step up enforcement of current securities law so that it sends the clear message to would-be misappropriators that such behavior will not be tolerated. Historically, the CSRC has not had the regulatory tools that it needed to conduct effective enforcement of the securities law. However, with the 2005 amendments to the 1998 Securities Law, positive change in the CSRC's capacity to enforce the law has occurred and further positive change seems possible.[93] The CSRC must demonstrate that it can and will enforce existing law or the climate of misappropriation probably will not decrease. In fact, it may increase.

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[92] Securities Law of the People's Republic of China, *supra* note 65, art. 74(5).

[93] New CSRC powers include: (1) authority to examine accounts and assets; (2) power freeze or seal assets; and (3) authority to confiscate assets; *see* discussion on Problems with China's Approach to the Misappropriation Theory, *supra* pp. 25-26.

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VI. CONCLUSION

While American securities regulation is a model for many foreign countries, its misappropriation regime does have its problems. These problems stem mainly from the existence of a fiduciary relationship requirement for assessing liability to those who misappropriate. American law on the matter has evolved and will hopefully continue to develop in a fashion that creates more equity in access to information for all investors. While there are obvious problems with the current American approach to misappropriation, the solutions are also obvious. The question that remains is whether there is the political will on the part of lawmakers to make the necessary changes.

China has used American securities regulation as a model for developing its own securities law, but it has not fallen into the trap of requiring a fiduciary relationship in order to impose misappropriation liability. Nevertheless, China's misappropriation scheme suffers from the inherent difficulties associated with state ownership of listed companies. More specifically, in many cases, there is no separation of the private and public sectors and the 1998 Securities Law does not list government officials other than those at the CSRC as parties with inside information. This lack of separation encourages misappropriation by other public officials who have inside information and who see opportunity for making huge profit using that information. Chinese law also has the potential for overly broad application, a problem that can be corrected by implementing a "use" requirement. In the end, both America and China need to institute reforms that will make their regulatory efforts more effective and that will provide more fairness in trading conditions for all investors.