

**A COMPARISON OF ILLEGAL INSIDER TRADING  
IN CANADA AND POST-COMMUNIST CHINA:  
GLOBALIZED MARKET ECONOMY  
AND THE ROLE OF LAW**

by

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## ABSTRACT

Although insider trading is a worldwide problem, researchers in criminology have conducted surprisingly little research on this topic. This dissertation examines insider trading regulation in Canada and China from a socio-legal perspective. The purpose of the study is to compare the social, political, economic, and legal origins of insider trading regulations and their enforcement in the two countries.

The dissertation begins with a historical account of insider trading legislation and policies in Canada (since *the Kimber Report* of 1965-66) and China (since *the Provisional Measures Controlling Securities Firms* of 1990). The central focus of this dissertation is on insider trading enforcement mechanisms. Major administrative and court cases are discussed in detail to illustrate how the insider trading offence is constructed in the different contexts of the established capitalist system in Canada and the “socialist market economy” in China, and how the securities regulatory commissions in the two jurisdictions have worked to enforce insider trading laws.

A major finding of the study is the paucity of insider trading cases and the lack of convictions for insider trading offences in both countries. Chinese insider trading regulation is more government-run, while the Canadian regulatory scheme is more industry and market oriented. In both cases, the threat of severe penalties should not be considered automatically effective. Canada and China have similarly lenient insider trading law enforcement. As the infrequency of insider trading cases in the two countries shows, the absence of a regular and consistent enforcement of the law is also a significant

problem both in China and in Canada. A primary challenge to enforcement comes from the fact that insider trading cases are too difficult to detect and prove in court. In addition, the relationship between the government officials and corporations is close and strong in both countries, though in different ways. The effectiveness of anti-insider trading provisions will arguably depend, in part, upon how the regulatory authorities charged with their administration conduct their work.

## **DEDICATION**

To my mother, my wife Ling and my two baby sons, George and Mason. Mason arrived in the world just two days after my defence. Their constant love and caring are every reason for where I am and what I am. My gratitude and my love to them are beyond words.

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# CHAPTER ONE: INTRODUCTION

## *Background*

“Poll respondents urge prison for insider trading” (Suhanic 2004: FP02)

“Ex-RBC Dominion exec Rankin to fight insider trading allegations” (No Author 2004: D4)

“Oil deal ruled insider trading” (No Author: 2003: B2)

“Cowpland fined for insider trading” (No Author 2003: 30)

“Prominent Vancouver businessman Iain Harris accused of insider trading” (No Author 2003: 16)

“Insider trading a serious problem in Canada” (No Author 2003: D4)

“Porn star jailed three months for insider trading” (No Author 2002: D4)

“Russia to probe insider trading ties to upgrade” (Tolkacheva 2004: FP10)

“Ex-Corel boss lands fine, ban for insider trading” (No Author 2003: 23)

“Billionaire fined \$2.2M for insider trading” (No Author 2002: G3)

“Scandals hit Japan's finance sector: Insider trading, payoff to racketeer alleged” (No Author 2002: FP14)

“Enron ex-CEO charged with insider trading” (No Author 2004: 36)

“Shenzhen Real Estate CEO Convicted of Insider Trading” (Yu 2003: 1-6)

A search for the phrase “insider trading” in the Canadian Newsstand database has resulted in about 2,500 such articles since January 1985. “Insider trading” refers to

situations where a person deals on the basis of price sensitive information that is not in the public domain, and at the time of the dealing, the information is likely to materially affect the price of the securities being traded.<sup>1</sup> Two main types of insider trading exist: the use of insider information by an insider for self-enrichment, and the leaking of information by an insider to a third person (“tipping”), allowing the third person to engage in illegal trade practices (Johnston and Rockwell 1998: 131).

Insider trading exists worldwide and affects all financial markets. It is one of the major challenges of our time. Millions of dollars have been involved in large-scale insider trading cases. Although the phenomenon of insider trading is not new and arguments in favour of prohibiting certain insider trading existed in the early years of the past century (for example, Wilgus 1910; Berle 1927), it did not become a major interest of the media and the public until the last 20 years. Since the 1980s, insider trading has increasingly become a hot topic. In 1988, Coffee (1988: 121) referred to it as “the representative white-collar crime of the 1980s.” The increasing media reporting of business morality cases in securities markets in more recent years makes the topic of insider trading even more high profile among the public.

The illegality of insider trading on non-public information, however, does not have a long history. The legal attitude toward such trading in securities markets has obviously reflected a laissez-faire philosophy instead of a government control approach (Pitt 1987: 5). In the US before the 1930s, for instance, there was no substantive legal prohibition on insider trading. Szockyj (1993: 5) observes that “[u]ntil the 1934

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<sup>1</sup> This is the definition of illegal insider trading. Insider trading in Canada can be legal where the information is in the public domain (requiring Insider Trading Reports), or illegal (as defined above). In China, however, all insider trading behaviours are considered illegal (See Johnston and Rockwell 1998: 131).

legislation, insider trading was tacitly viewed as a perk by corporate executives.” In fact, as Shulman writes, “...many, if not most, of America’s great fortunes accumulated at the end of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup> were built with information ...that was not available to the public at large” (1970: 122, as quoted in Szockyj 1993: 5). The adoption of “blue sky laws” in the early 1900s required the full disclosure of material non-public information, but did not prohibit insider trading behaviours. In the leading case of *Strong v. Repide* (1909), the US Supreme Court held that a company official is obliged to disclose his or her identity and non-public information when he or she trades the company stocks. It was not until 1934 that Section 10(b) and Section 16 of the *Securities Exchange Act* established legislative prohibition on insider trading on privileged information. The landmark US Supreme Court case of *SEC v. Texas Gulf Sulphur* in 1968 and the subsequent cases represented further judicial confirmation of the illegality of insider trading activities (Reichman 1989: 188; Szockyj 1993: 7-18). Similarly, in other jurisdictions like Canada, Britain and Australia, legislation was eventually introduced that made trading on insider information an offence (see: Tomasic 1991: 5; McVea 1993: 67; Johnston and Rockwell 1998: 131), although these countries regulate insider trading in different ways.

Studies of insider trading are not very long established or well developed. Until the 1980s, criminology and other social sciences paid very little systematic attention to this crime and its regulation. There had been, of course, some significant contributions, such as Manne’s law and economics research (Manne 1966), which did inspire academic debate. Subsequently, over the past quarter century, a growing literature on insider trading and its regulation has developed in criminological studies. The nature of insider

trading, involving as it most often does individuals of some status and respectability that affords them access to information inside of financial markets, lends itself to analysis as an aspect of white-collar crime. The work of Shapiro (1984), Tomasic (1991), Reichman (1989, 1993) and Szockyj (1993) each provides comprehensive analysis of insider trading and law enforcement in this area. In Britain, McVea (1993) and Rider and French (1979) are notable legal scholars in this field. In Canada, Brockman's (1998) work deals with the problems of self-regulation and law enforcement generally, and offers a very useful framework for examining securities regulation in particular. Armstrong (1997, 2001) provides an excellent historical perspective on securities regulation. Johnston and Rockwell (1998) present a thorough survey of the philosophy, history, scope, machinery and specific elements of Canadian securities regulation in general, with a whole chapter reviewing insider trading. Most recently, using statistical data from 1987 to 2000, McNally and Smith (2003) make the first ever assessment of compliance with insider trading laws and insider trading enforcement in Canada. In China, contrastingly, research on insider trading has tended to be the abstract body of law review literature which has done little more than to discuss the present securities legislation and how to improve the law in this area to keep in accordance with the international practice (Bai 1999; Gu 1998, 2000). Little empirical work has been done so far in China on insider trading.

Many of the findings by various researchers on insider trading in different jurisdictions are very informative and instructive. However, studying insider trading may be more complicated than supposed. In every jurisdiction, the socio-legal and criminological research dealing with insider trading and law enforcement has been limited. The Canadian and Chinese literature on insider trading is even less developed,

with the exception of some work on the overall securities regulation as shown above which has served as an inspiration, and as useful background material, for this current study of insider trading regulation.

Some forms of insider trading are deemed illegal in all countries with major markets and in most of the other industrialized countries without major markets. However, every country has its own form of regulation. In some countries, the regulation of insider trading is very mature. In other countries, the regulation is still in an embryonic stage of development. The enforcement of insider trading, like the legislation, varies by country. Insider trading used to be recognized merely as a domestic problem before the 1970s. However, the globalization of the securities markets has enabled insider trading to become a very commonplace international practice. It is against this background that I am interested in conducting a comparative study of insider trading regulation in Canada and China.

### ***The Canadian and Chinese Legal Contexts***

As a key industrialized country, Canada has a relatively longer tradition of insider trading regulation than China. In 1965, the Kimber committee was established to consider, among other things, complaints about insider trading, unfair take-over bids, and the lack of continuous disclosure of corporate information. The Kimber Report stressed that corporate insiders have done nothing wrong in buying and selling stocks in their own companies per se. Investments in their own company may induce corporate directors and officers to work harder. However, the Kimber Report emphasized that a corporation's insiders should be prohibited from trading for their own benefits or advantages on the basis of material non-public information about their firm. The insider trading prohibition



is based on theories of “equal access to information,” “efficiency of the market,” “property right of material non-public information,” and above all investor protection (Johnston and Rockwell 1998: 131; Osode 1999: 166).

Another major characteristic of the Canadian context is that there is no national scheme of securities regulation. However, according to some commentators, efforts to create some harmony in legislation across the provinces have so far worked efficiently, through the activities of the Canadian Securities Administrators (Johnston and Rockwell 1998: 131; Osode 1999: 166).

The securities markets in the People’s Republic of China have attracted much attention very recently from the international business world and media. After the founding of the People’s Republic in 1949, private ownership, characterized as “vicious capitalism,” was removed completely through “the socialist transformation.” The re-emergence of securities markets, as a typical way of private, third party ownership of enterprises, did not happen until China commenced its economic reform in 1978. As a result of the reform and opening-up policy, securities markets soon emerged to meet the needs of building “socialism with Chinese characteristics” and the so-called socialist

market economy.”<sup>2</sup> To further open its financial markets in the future, strengthen investor confidence, and prevent erratic financial expansion, the Chinese government has increasingly toughened regulations against a variety of abuses, including the prevalent insider trading offences. After experimenting with a patchwork of securities rules since 1990, the first comprehensive securities legislation of 1998 has gone further to establish an even stricter legal liability framework to deal with insider trading and the misuse of investors’ money. The Chinese government has also established the Chinese Securities Regulatory Commission (CSRC),<sup>3</sup> and recruited and trained more market regulators and given greater power to them. In order to ensure investors’ confidence in Chinese securities markets and to catch up with the pace of the world market economy, the Chinese regulators face the challenges of achieving regulatory standards in securities markets which the major capitalist jurisdictions have developed over so many decades (Gu 1998: 10-25).

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<sup>2</sup> On the basis of the economic structural reforms since 1978, the 14<sup>th</sup> Chinese National Congress (held in October 1992) put forward as the goal of China’s economic reform the establishment of a socialist market economy, signaling a historic change in the development of China’s national economy as well as political and social institutions. Within this system, public ownership will continue to be the main form of ownership as various types of ownership are jointly developed. The operation mechanism of state-owned enterprises will be further transformed to meet the requirement of a market economy. The property rights and responsibilities of such enterprises will be clearly defined. The functions of the government are separated from those of enterprises. An open and unified national market system will be established, providing for reciprocal flow between domestic and international markets. Governmental functions in administering the economy are to be transformed so as to establish an optimal macro-regulatory system for the market economy which will be supervised by indirect means, guaranteeing the healthy development of the national economy. The state encourages people to become rich and allows some areas and people to be richer than others before an overall level of prosperity is reached. Although equality is displaced by efficiency in this system, economic development and social stability are both important (Deng 1992: 12-28).

<sup>3</sup> The CSRC, a ministry rank unit directly under the State Council, is authorised to conduct supervision and regulation of the securities and futures markets in accordance with the law. It has a centralised supervisory system for securities and futures markets and assumes direct leadership over securities and futures market supervisory bodies. It organises the drafting of laws and regulations for securities markets, and formulates the principles, policies, rules, and development plans related to securities markets.

### *Scope and Object of the Study*

It is worth studying the two different insider trading regulation systems in the context of the globalized market economy. This dissertation involves a comparison of insider trading regulations enforcement in Canada<sup>4</sup> and China.<sup>5</sup> It will be based largely around the globalization of securities markets, Canada's efforts to increase cooperation and coordination between provinces and with other countries, and China's economic and social reform since 1978 and its introduction of insider trading offences and regulation in post-communist China. While legislative aspects of regulating are examined in a brief way as background information, the central focus of this dissertation is on insider trading enforcement mechanisms. I have selected the last 19 years to look at all the insider trading cases in British Columbia, Ontario and Alberta. The intellectual puzzle here is how the insider trading offence is constructed in the different contexts of the established capitalist system in Canada and the "socialist market economy" in China, and how the legislatures, the courts and the securities regulatory commissions in the two jurisdictions have worked to mold the offence of insider trading. I will examine the issues involved in the regulation of insider trading from a criminological and sociological viewpoint. Based on the social contexts that give rise to and reaffirm the regulation of insider trading in Canada and China, this study compares how the securities commissions in the two countries actually implement insider trading law.

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<sup>4</sup> In Canada, the regulation of securities markets is a provincial responsibility. While the laws on insider trading in the provinces are substantially similar (Osode, 1999: 168), their enforcement will vary from province to province. This dissertation will focus on cases in the three major English-speaking jurisdictions (British Columbia, Ontario and Alberta, and will for convenience be collectively referred to as Canada); however, interviews will be limited to participants in British Columbia.

<sup>5</sup> In China, on the other hand, the securities regulation and its enforcement are uniform at the national level.

## ***Organization of the Dissertation***

Chapter 2 comprises a discussion of the existing literature related to insider trading. It looks at research methods for studying insider trading, varying approaches to explaining the etiology of insider trading, theoretical perspectives on white-collar crime and insider trading regulation and the rationale for prohibiting insider trading, and finally the effectiveness of the law and enforcement in this area.

Chapter 3 is a discussion of the methodological approach and design. It uses critical socio-legal research as a framework, under which an integration of data collection methods has been developed. It presents research questions, data sources, collection methods, as well as coding and analytical techniques.

Chapter 4 provides a historical account of insider trading legislation and policies in Canada (since the *Kimber Report* of 1965-66) and China (since the *Provisional Measures Controlling Securities Firms* of 1990).

Chapter 5 is an analysis of insider trading cases in Canada from 1985. Both administrative and judicial cases are discussed, with a focus on the former. Major cases are examined in detail to illustrate the way in which insider trading enforcement was carried out. Detection, investigation, charge, and prosecution policies and practices are addressed through case analysis and interviews.

Chapter 6 presents a discussion of insider trading cases in China over the past decade. Similar to Chapter 5, Chapter 6 analyses the enforcement policies and practices of insider trading regulation in China, based upon administrative and judicial cases, interviews and policy documents.

The concluding chapter brings together a comparison between Canada and China, and provides suggestions for future insider trading regulations in the context of the globalized market economy.

## **CHAPTER TWO: REVIEW OF THE LITERATURE**

As has been noted, insider trading has received increased attention only in the last two decades. There is a dearth of published research on insider trading in Canada, and even less in China. Only one published work specifically deals with insider trading legislation in China (Li 1998). Insider trading studies in the US, Australia and the UK will be reviewed to provide a basis for conducting a socio-legal study of insider trading regulation in the Canadian and Chinese contexts. This chapter summarizes the literature that has been written in the area of insider trading, by focusing on related socio-legal research and its theoretical development. It is divided into the following four sections: 1) research methods for studying insider trading; 2) theories and perspectives explaining the etiology of insider trading; 3) the contemporary debate on white-collar crime regulation and the rationale for prohibiting insider trading; and 4) the effectiveness of the law and enforcement.

### ***Research Methods for Studying Insider Trading***

The study of insider trading is more difficult for researchers than many other areas of criminological research. Insider trading is usually an extraordinarily complicated crime, which may involve several large or small corporations, a number of market actors in various positions, and very intricate and long-term transactions. The offenders are much less accessible than perpetrators of many other forms of crime, because they are usually powerful people and hence more afraid of losing face and reputation (Geis 1984: 138). The extent and characteristics of insider trades are less likely to be found from

official crime statistics, since they are often divided among different regulatory agencies and the data tend to be recorded during an advanced stage of the proceedings (Shapiro 1984: 6). Furthermore, the government and corporations are considerably reluctant to support and sponsor insider trading research. However, in the late 1970s, the US government funded some insider trading research projects. Shapiro was one of the few fortunate scholars who received government financial support for such a study. After several attempts, she was also granted access to the Securities and Exchange Commission (SEC) enforcement records. Nevertheless, she still attracted suspicion and distrust from the agency early in her observations (Shapiro 1984: 193-196). Furthermore, such studies might be exposed to pro-government or single-source bias, since the sponsors would often measure them according to their own ideological interests.

Despite the difficulties researchers may encounter, scholars of insider trading have tried various research methods to examine the problem. Case studies, surveys and interviews have been used. Official data are applied to analyze the extent of insider trading. Direct observation has been adopted by some researchers who are fortunate enough to have access to criminal companies or social control agencies. Historical accounts, legal documents, and other archival data are widely employed and examined. Many scholars, such as Shapiro (1984) and Tomasic (1991), have adopted multiple methods to explore this phenomenon.

### **Interactive or Survey Methods**

Interactive or survey methods including questionnaires and interviews are perhaps most suitable for the study of attitudes, opinions, and beliefs, and can also be employed to explore a respondent's experiences and thoughts. An interview involves an on-going

question-and-answer exchange between the researcher and the respondent, while a questionnaire involves written responses to a prepared question document (Palys 1997: 144; Maxfield and Babbie 2001: 246-273). One primary advantage of interactive methods is the opportunity they provide for personal interaction between the interviewer and the respondent. Interactive methods are particularly useful for examining insider trading because researchers are interested in people's perceptions of insider trading and its regulation.

Examples of interactive methods can be found in existing insider trading literature. Tomasic (1991), in his *Casino Capitalism? Insider Trading in Australia*, provides a valuable survey study of the attitudes and experiences of securities market actors and observers toward insider trading and its regulation. He combines questionnaire and interview techniques in order to obtain person-to-person perspectives. He presented 66 open-ended questions in 79 interviews involving 99 key players in Australia, including brokers, lawyers, merchant bankers, financial journalists and enforcement officials. He also interviewed some stock exchange and enforcement officials and insider trading researchers in other jurisdictions for a comparative analysis (Tomasic 1991: 143-145). Tomasic concludes from his interviews that insider trading in Australia is both prevalent and harmful, and that it "has reached a point where the current corporate and securities laws have reached their limits in being able to control the social and economic problem of insider trading" (1991: 54). He infers from the responses that insider trading occurs predominantly in small capitalization stocks related to takeover activity, and is most likely to be committed by corporate directors and corporate officers (1991: 51-54).



Despite the many advantages of interactive methods, they possess obvious limitations when used in studying insider trading. A major challenge in interactive methods is how to minimize problems of interviewer and respondent effect or bias, which may be responsible for distorted results (Friedrichs 1996: 44). Dempsey (1996: 265-273) suggests that Tomasic's inferences from the evidence are open to doubt, because the respondent may be biased and "may not actually have had an opportunity to witness the occurrence and is reporting rumour or hearsay" (1996: 267). In addition, many participants may not have understood what was then prohibited by the law.

Other challenges facing interactive methods include obtaining a representative sample from which one can generalize, gathering sufficient and meaningful data, and avoiding ethical problems.

### **Observational Methods**

Observational methods provide another very useful strategy for collecting data on human behaviour. They involve "a variety of strategies in which the researcher studies a group in its natural setting by observing its activities and, to varying degrees, participating in its activities" over a period of time (Hagan 2003: 209). Hagan has discussed the four researcher roles in participant observation by drawing on Buford Junker's (1960) typology of observational methods: complete participation, participant as observer, observer as participant, and complete observation (2003: 211).<sup>6</sup>

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<sup>6</sup> Complete or covert participation refers to a situation where the researcher is a disguised member of the group and even manipulates group activity. The "participant as observer" or participant observation method takes place when the researcher makes his/her presence known to the group and tries to observe group activity in an objective way. The "observer as participant" type is the same as in-depth interviews. Complete observation is an experimental or quasi-experimental method. In reality, "participant as observer" or "observer as participant" methods are more frequently used by social scientists (Hagan 2003: 211).

Observational methods pose the problem of gaining entry into and acceptance by a group. Since it is difficult to get access to either offending companies or enforcement agencies, this method has been used to a relatively limited degree in studying insider trading. The only example is Shapiro's (1984) study of the US Securities and Exchange Commission (SEC). She gained access to the SEC enforcement department merely by coincidence, because she became familiar with officials of the SEC when they participated in a special program at her school. She spent six weeks during the summer of 1976 observing daily practices of the SEC headquarters and a regional office. During this time, she engaged in formal and informal interviews with the staff, read various non-public records and materials, and attended daily meetings and private hearings. Based on observation and other methods, she provides a detailed account of the SEC's enforcement activities. She offers readers the opportunity to rethink their understanding of insider trading and other securities offences, and the SEC enforcement, and makes suggestions for improving existing SEC intelligence strategies.

However, as Friedrichs (1996: 45) suggests, observational methods have limitations when used to study white-collar crimes and their enforcement. It should be noted that even Shapiro herself admits the difficulties of conducting participant observation research on white-collar crime enforcement activities (Shapiro 1984: 194-96). Although Shapiro identifies observation as her major research method, her analysis relies excessively on cases gathered from archival data. Although she interviewed many SEC personnel, there are no direct quotes from the interviews in her book. Her account, therefore, is missing the anecdotal texture one would expect from ethnographic socio-legal research.

## **Analysis of Secondary Data**

One of the most popular research methods in studying crime may be the analysis of secondary data like statistical information by official agencies. Nevertheless it is not common for criminologists to use this method in their research of insider trading, due to the lack of clear-cut statistical information on this specific offence. Actually economists are more likely to use this method to analyze market efficiency, bid-ask spread patterns, or a comparison of returns, because they believe that it is a more objective way to understand the extent and effect of insider trading (Dempsey 1996: 272-273). In criticizing Tomasic's interview method, for example, Dempsey argues that methods using statistical share price information "might result in more objective and quantifiable results" on insider trading (1996: 266).

In *Crimes of the Middle Classes*, Weisburd, Wheeler, Waring and Bode (1991) present a typical statistical analysis of a large sample of white-collar offenders. Weisburd and his colleagues analyzed data collected from federal pre-sentence investigation reports in the US on 1,094 individuals convicted during the mid-1970s for eight types of white-collar crime: antitrust violations, securities fraud (including insider trading), mail and wire fraud, lending and credit institution fraud, false claims, bribery, tax violations and bank embezzlement. Weisburd *et al.* conclude that most white-collar crimes involve few people and small amounts of money. Most white-collar criminals come from the middle rather than the upper classes. Judges often punish them more harshly than lower-class criminals. However, Weisburd *et al.* show that securities fraud cases frequently involve more offenders and victims and loss of \$100,000 or more, because securities fraud offenders have easier access to organizational resources.

Watson and Young (1999) empirically analysed insider trading around takeover announcements by employing data from the Australian Securities and Investments Commission (ASIC) databases for the period of January 1996 to June 1998. They conclude that insider trading tends to occur in the context of takeover announcements, and suggest that there exists a “certain disregard for the regulatory authorities” (1999: 21).

Khan and Lamba (2001) extracted data on purchases and sales by insiders from the SEC’s monthly *Official Summary of Security Transactions and Holdings* over the period of 1977 to 1993 to examine the trading behaviour of corporate insiders before and after the implementation of *the Insider Trading Sanctions Act (ITSA)* in 1984, via exchange listings by the US National Association of Securities Dealers Automated Quotations (NASDAQ) stock market firms. They found that the increased sanctions imposed by ITSA had little deterrent effect on the trading behaviour of corporate insiders around the exchange-listing event.

A more recent study by McNally and Smith (2003) examined statistical data concerning 1,812 stock repurchase programs gathered from the Ontario Securities Commission (OSC) over the period 1987 to 2000 to look at compliance with insider trading regulations of the OSC and the Toronto Stock Exchange (TSX). In contrast to the very small number of prosecutions, McNally and Smith found sizable evidence of insider trading and reporting violations. For example, almost half of the repurchasing firms did not disclose their trades to the OSC. McNally and Smith also provided evidence that many insiders are committing insider trading in advance of material information announcements.

Although official statistical data can provide large-scale information and look precise, the major weakness of such data is that they have been collected “for agency purposes and therefore may not contain the degree of accuracy or operationalization the researcher desires” (Hagan 2003: 246). Not all offences are enumerated in official statistical reports, because some events will pass through the various filters such as the crime reporting and recording practices. Their validity and reliability are sometimes questionable (Palys 1997: 219-225). Statistical data may also be interpreted in various ways depending upon the researcher’s theoretical orientation (Friedrichs 1996: 46).

### **Analysis of Archival Data**

The analysis of archival data or written documents is widely used by insider trading researchers and other white-collar criminologists, since these materials are far more accessible than many other data. Usually much evidence of insider trading laws and cases is available in written documentary form. Armstrong (2001), in his *Moose Pastures and Mergers: The Ontario Securities Commission and the Regulation of Share Markets in Canada, 1940-1980*, through reviewing numerous historical documents, was able to reconstruct the problems of fraud, misrepresentation, insider trading, and manipulation of prices, which plagued the securities industry and regulation development in Canada between 1940 and 1980.

Szockyj (1993) used a great number of historical records including government documents, court cases, administrative hearings and media reports, to reconstruct the history of insider trading law in the US from 1934 forward. She found that the criminalization of insider trading is not listed in legislation but has been evolving all the time out of interaction between the courts, the SEC and defendants. From her

examination of archival records, she also discussed how insider trading cases are detected, prosecuted and sentenced.

In addition to interviews, Tomasic's (1991) study also relies, to a certain degree, on archival data on court cases and government records like findings of the Griffiths Committee of 1989 published in *Hansard*. His comprehensive examination of these data shows that the courts are usually reluctant to regulate insider trading. Furthermore, it is difficult to prove an insider trading case, due to the major elements of the offence which must be established. Using archival data from other countries, Tomasic was also able to conduct a comparison of judicial approaches in insider trading cases in Australia, the US and the UK.

Although archival research is less expensive and more accessible than many other qualitative data, it presents the problems of selective deposit, selective survival and therefore incompleteness. For example, government archives are more likely to be available than other archival sources, yet may not reflect the reality. Policy shifts in recording practices may produce different sets of archival data on the same topic (Palys 1997: 218-219). Fortunately, Szockyj and Tomasic seem to realize the hazard of using a single research method, and therefore, have combined archival research with other methods like interviews and case studies.

### **In-Depth Case Studies**

In-depth case studies have been more commonly adopted in studies of white-collar crime than in conventional crime research. For example, in *The Law and Insider Trading*, Szockyj (1993: 77-102) presents an insightful study of a common insider

trading case, *the SEC v. Carl Karcher et al.* (1988), uncovered by the SEC in the US. The enforcement techniques of both civil and criminal options are vividly illustrated by this study. In addition, this case study is well presented through the author's interviews and existing documents including trial notes and media articles.

Journalistic field research is another type of case study, which has been an important source of knowledge for academic researchers. As Friedrichs (1996: 41) observes, “[n]ot only can such [journalistic] reports provide us with a vivid image of illegal activity; they can also generate hypotheses for further, more systematic study.” Goid and Willis (1998), both Globe and Mail reporters, incorporate a case study method into a journalistic book, *The Bre-X Fraud*.<sup>7</sup> Using the records of those who personally visited the Busang property and met the on-site players, they were able to recreate the drama and tension that pervaded the Bre-X scandal. Their insight into the entire Bre-X scandal has exposed the anatomy of probably the world's biggest stock fraud.

The major advantage of case studies is their in-depth and qualitative exploration of a particular event or a few persons. The major problem of such methods is “possible researcher bias and atypicality of the cases chosen for analysis” (Hagan 2003: 229). This problem is probably even more evident in journalistic case studies. In *the Bre-X Fraud*, for example, many of the conclusions are based on the authors' personal views and speculations, without sufficient supporting material. Szockyj (1993) lessens this problem by examining a number of court cases before her in-depth case study of *the SEC v. Carl*

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<sup>7</sup> Former Bre-X chief geologist John Felderhof was charged with illegally selling \$84-million worth of shares on inside information, well before the world found out that the company's Busang gold discovery was a hoax. Bre-X investors lost millions of dollars when the scam was revealed in the spring of 1997 and the stock price collapsed. Many Bre-X officials, by contrast, became multimillionaires. Mr. Felderhof has denied any wrongdoing. This case is on trial at present.

*Karcher et al.*. She discusses this particular case only to illustrate “the way insider trading cases are handled and adjudicated” (1993: 75).

Having reviewed these methods, we must acknowledge that each method has limitations in its ability to yield an understanding of insider trading. In-depth case studies, for example, involve a limited number of cases, yet have myriad prospective explanatory variables to choose from. Some scholars may overlook negative elements in the cases in order to achieve consistency with their theories. By using interviews, we are sometimes not able to control respondents’ possible biases. Dempsey’s (1996: 271) criticism of Tomasic’s work (1991) is understandable since the respondents in the study are mostly regulators or observers who may harbour institutional bias against insider trading. Observational methods can involve suspicion and distrust which may affect the research. In fact, Shapiro (1984) herself admits that there may be research bias existing in direct observation derived from a single data source. Statistical analysis, which may ignore respondents’ perception of insider trading, would usually decontextualize human behaviours and social phenomena (Steckler et al. 1992: 1-8). Finally, the main limitations of documentary analysis are the selective nature of what is recorded and what is found by the researcher. For instance, when Johnston and Rockwell (1998: 12-13) discuss the origin of the US “blue sky” laws, they have only noted one explanation of it and overlooked other perspectives, which leads to historical inaccuracies (see Nicholls 1998: 167-168).<sup>8</sup> This review shows that we should be prudent in choosing research methods

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<sup>8</sup> Johnston and Rockwell’s (1998: 12-13) historical material suffers from over-reliance on secondary sources. In referring to the supposed origins of the US state-level “blue sky” securities legislation, the authors state that “blue sky” laws were passed to prevent eastern stock promoters from bilking simple Midwestern farmers. This is only one of the explanations, which has been persuasively challenged by Macey and Miller (1991) at an earlier date. According to Macey and Miller (1991), such laws were passed largely at the behest of small local banks who sought protection from competitors.



for complicated insider trading studies. The method chosen should depend on certain research conditions. When we use a method, we should try our best to recognize and work within its limitations. It would probably be better to use a combination of methods that complement each other, i.e., “triangulation” (Denzin 1970: 300-301; Flick 1992: 175-197; Glaser and Strauss 1978: 53-57). The following sections will review the major theoretical and policy contributions of existing insider trading studies.

### ***Theories and Perspectives Explaining the Offence***

The task of explaining the causes of human behaviour is complex. There is a growing body of research and analysis on the etiology of crime and criminal behaviour, which includes various theories and perspectives ranging from the Italian Classical School to different critical theories (Lily, Cullen, and Ball 1989; Akers 1994). However, theories on crime and deviance have tended to neglect white-collar crime. Although modern criminologists are now adapting well-known criminological theories to the study of white-collar crime, there are still very few theoretical explanations of or applications to insider trading. The aim of this section is to review the existing theories and perspectives which attempt to explain insider trading. Generally, modern efforts to theorize the causes of white collar and corporate criminality are categorized into two major types: individualist theories and organizational theories.

### **Hirschi and Gottfredson’s General Theory of Crime**

Hirschi and Gottfredson (1987: 957) believe that “there is no obvious theoretical value in distinguishing white-collar crimes [such as antitrust violations and insider trading] from analogous blue-collar crimes,” and that “there is every reason to think that a single theory will apply to all types of white-collar offences.” Gottfredson and Hirschi

(1990: 15) provide their own definition of crime as “acts of force or fraud undertaken in pursuit of self interest.” Low self-control is supposed to explain an individual’s propensity to commit crimes, just as high self-control explains an individual’s likelihood of conforming to social norms and laws (Akers, 1991: 201). Gottfredson and Hirschi argue that the level of self-control depends on the quality of parenting in a child’s early life. Poor parenting can make a child impulsive, insensitive, physical (as opposed to cerebral), risk-seeking, short-sighted, nonverbal, and therefore poorly self-controlled (Gottfredson and Hirschi, 1990:90). They also believe that involvement in conventional commitment would keep someone too busy to commit deviant behaviours. Six elements of self-control are presented, one of which is that “[c]rimes require little skill or planning” (Gottfredson and Hirschi 1990: 89). According to Gottfredson and Hirschi, criminals do not specialize in one type of crime, but may commit various forms of crimes, including both white-collar and street crimes. This theory is promulgated as applicable to age, gender, and racial variations in crime, social correlates of crime, cross-cultural comparisons, white-collar crime, and organized crime.

Many scholars have criticized this theory and argue that white-collar crime does not seem to be adequately explained by this theory. For example, Benson and Moore (1992: 270) maintain that individuals have already proven that they can endure postponed gratification in order to achieve an advanced education that permits them to commit white-collar crimes. Friedrichs (1996: 227) states that, for Gottfredson and Hirschi, “white-collar crime principally means low-level employee embezzlement and marginal types of fraud that are often committed by relatively poor individuals who are not part of the white-collar class.” Some scholars use insider trading as a typical example to show

the inefficacy of Gottfredson and Hirschi's general theory to explain white-collar crimes. Polk (1991: 578) argues that, contrary to what Gottfredson and Hirschi claim, financial crimes such as insider trading are not interchangeable with street crimes, because they "require... rather specialized knowledge", and "[are] planned with remarkable complexity".

In a recent study, Szockyj and Geis (2002) examined Gottfredson and Hirschi's general theory by analyzing official data of insider trading violations and crimes collected from civil cases by the SEC and criminal charges by the US Department of Justice, over the period of 1980 to 1989. Szockyj and Geis differentiated insider trading from other white-collar crimes, in the way that insider traders engage in illegal trading mostly in order to achieve personal but not organizational benefits (2002: 282). They report that "absence of self-control might be one of the factors that correlated with violation of the insider trading laws, particularly for the segment of insider traders from the securities industry"(2002: 283). They claim that many insider traders in their study were impulsive and willing to take risks to seek lucrative opportunities. They also conclude that most insider trading offenders did not employ much skill or planning in their illegal trading, which they think would support Gottfredson and Hirschi's argument that crimes do not need specialized knowledge. However, Szockyj and Geis note that the self-control theory cannot explain some insider trading offenders' "preference for loss avoidance and altruistic tipping"<sup>9</sup> (2002: 283-284). They argue that insider trading served to increase the certainty of a profitable outcome, which is contrary to the risk-taking thesis. And the

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<sup>9</sup> Altruistic tipping happens when an insider discloses ("tips") material nonpublic information to others and/or directing others to trade securities in light of such information not for the tipper's own interests, but for the benefits of others.

altruistic tipping behaviour is not consistent with Gottfredson and Hirschi's definition of crimes as hedonistic acts (2002: 283).

While Szockyj and Geis's (2002) study represents an important step towards testing the general theory in the case of insider trading, whether their sample from official data is representative of all insider trading illegalities is open to doubt. Many more sophisticated insider trading events may not be pursued either civilly or criminally, with the result that they are excluded from the official data recorded by the SEC and the US Justice Department. Many small insider trading offenders may employ little skill and demonstrate impulsiveness, risk-taking and lack of self-control in their illegal trading, as Szockyj and Geis (2002) claim in their study. However, those theorists who emphasize self-control in explaining insider trading still need to provide more evidence to prove their case.

### **Opportunity Theories**

Opportunity theories originate from Emile Durkheim's (1951 [1897]) theory of anomie. For Durkheim, anomie was a consequence of a sudden disturbance, crisis or rapid change. Some scholars have attributed insider trading crimes to such a normless situation. Lilly, Cullen and Ball (1989: 67) note that the prevalence of insider trading on Wall Street in the 1980s "seemingly provides one example of how the widespread preoccupation with amassing fortunes results in a breakdown of institutionalized norms" that "fosters the unbridled pursuit of pecuniary rewards." While a sudden social change plays a possible role in an outbreak of insider trading crimes, it can be argued, however, that insider trading crimes also exist in a relatively stable society such as Canada, for

which at least Durkheim's version of anomie theory cannot provide a convincing explanation.

Robert Merton (1996 [1938]: 672-682) borrowed the term anomie and applied it to the problem of crime in America. Unlike Durkheim, Merton does not associate anomie with sudden change, but with strains built into a social system. Merton argues that the real problem is created by a social structure that holds out the same goals for economic success to all its members without giving them equal means to achieve them. Those who lack legitimate means to achieve such success may attempt to realize their goals by illegal means.

Drawing from Merton's theory of structural strain, Richard Cloward and Lloyd Ohlin (1961) advanced differential opportunity theory. Cloward and Ohlin (1961: 150) argue that deviant behaviours are a function of the opportunity structure. In order to become a criminal, one must have access to the illegitimate means of attaining material goals. Additionally, a person must be denied access to legitimate opportunities for attaining material goals.

These theories have primarily been used to explain crimes of the lower classes who have the least legitimate opportunities for achievement. However, some scholars argue that they are also applicable to white-collar crimes including insider trading. For example, Friedrichs (1996: 233) notes that "some white-collar crime may be best understood as a response to a situation in which the attractions of particular illegitimate opportunities, whether pre-existing or created, outweigh those of legitimate opportunities." Many researchers argue that insider trading occurs when there is an opportunity or situational inducement to commit crime. The respectable status of the

insider in securities markets often provides special opportunities for engaging in this type of illegality. Thus many researchers maintain that insider trading might be most effectively prevented by reducing opportunities and increasing the risks. In this way, these researchers seem to regard insider trading offenders as merely occasional criminals who commit crime depending on the availability of opportunities, but do not make crime their occupation (Smith 1982: 24-28).

Shapiro (1984: 94) argues that offenders in securities markets commit trust violation because of the loopholes in regulatory intelligence strategies. She found that securities offences are "differentially vulnerable to discovery and to particular methods of detection," and hence different intelligence strategies will determine the kinds of violators being detected. Therefore, increasing the chances of being caught by enhancing detection technologies will substantially reduce insider trading offences.

Tomasic (1991: 69-78) is another well-known scholar who attempts to explain insider trading crime with opportunity theories and argues that the opportunities for insider trading in Australia are still extensive. Although he recognizes that "other factors are also at work" (1991: 69), his main focus is on the relationship between opportunity and the offence. Conflicts of interests, companies' values and readiness to reveal price sensitive information to brokers and large shareholders, market conditions, professional or peer group tolerance, and situational factors such as mineral exploitation and company takeovers all provide major opportunities for the crime. Low ethical standards have been emphasized by the author as the most criminogenic opportunity (1991: 76-78). This observation is arguably based on Sykes and Matza's (1957) neutralization theory,

according to which neutralization of ethical restraints may justify questionable behaviours as routine, unproblematic and necessary.

The argument that insider trading offences are caused solely by opportunities is not especially convincing without sufficient evidence. The pattern of etiologic factors that generate insider trading is indeed much more complex. Opportunity theories are vague on why individuals facing the same opportunity act differently, and cannot explain the personal dimension of individual offences.

### **Integrated Theory of Opportunity and Motivation**

According to many authors, all criminal behaviours require two basic elements, namely, motivation and opportunity, which must coincide before a crime can occur (Braithwaite 1989). It may be because of this factor that opportunity theory advocates cannot explore more detailed and practical proposals of law reform.

Szockyj (1993: 103-124) has attempted to develop an integrated theory of such illegality that incorporates the two factors, motivation and opportunity. She has combined the rational choice approach of the classical school (Beccaria 1963 [1764]), Sykes and Matza's (1957) techniques of neutralization and Cloward and Ohlin's (1961) differential opportunity theory to explain insider trading crimes.

Szockyj (1993: 104) notes that individuals choose to engage in insider trading to gain potentially huge financial rewards, improve their career or benefit their employers after a rational cost/benefit analysis. Although insiders have to consider "the moral costs and the perceived likelihood of detection and prosecution," they are able to justify their insider trading behaviours by disagreeing with the rationale for regulation (1993: 104).

They can also argue that insider trading is harmless and victimless and hence deny responsibility and liability for such trading. The absence of a general legislative definition of insider trading and the low risk of being caught and punished also encourage insider traders to commit insider trading (1993: 108-113).

Szockyj (1993: 114-123) goes on to note that opportunities to engage in insider trading are distributed unevenly across organizational positions in corporations and financial institutions. Most corporate employees have little opportunity to learn about and use insider information unless they come across it by happenstance. Corporate owners and managers have better opportunities, because they have greater access to material information about their corporations. But even their opportunities pale in comparison to those that are available to investment bankers and securities traders. Those who occupy these interstitial positions between buyers and sellers have access to information about multiple corporate plans and hence greater opportunity to engage in self-dealing through trading on privileged information.

However, Szockyj says little about the cultural, political and structural forces that lie behind these factors. For instance, she fails to explore the culture of competition, materialism and eroded business ethics which may generate motivations for the violation of law. She also fails to explain the fundamental reasons for different opportunities in a society, for example, unequal economic or class positions.

Reichman (1989) maintains that opportunities to violate trust exist “in social relationships where one entrusts resources, authority, or responsibility to another” (1989: 198). Such opportunities are greatly connected to the ineffectiveness of informal controls, like norms of fiduciary responsibility, and formal regulations which are used to prevent



market participants from engaging in insider trading. Several factors contribute to undermine formal and informal controls and hence intensify opportunities for trust violation. The extension of information networks, new investment products, the increase in market complexity, and regulators' lag in surveillance,<sup>10</sup> have weakened traditional modes of informal control and thus enhanced opportunity structures (1989: 193-195). Reichman also notes that trust violation will not happen without the element of people's motivation. She argues that motivation comes from the capitalist business culture. Since competition in the securities industry has induced individuals and firms to make short-cut profits, there are increasing pressures to neglect traditional forms of restraint. Furthermore, organizational flux and cultural change in contemporary markets have aggravated investment bankers' "role ambiguity," which may lead to the collapse of traditional controls and "delinquent definitions of behaviour" (1989: 195-198).

Reichman's theory is instructive in the way that she integrates social psychological and structural explanations into one general theory, by asserting that trust violation in today's securities markets is caused by the coincidence of motivation and opportunity. As many studies show, social psychological interpretations alone fail to acknowledge the structural factors that shape criminal behaviour, while an exclusively structural analysis overlooks the personal aspects of criminal behaviour and cannot explain any individual illegality (Braithwaite 1989: 333-358). A complete understanding of trust violation requires us to connect the two factors in a systematic way.

However, Reichman's theory has put undue stress on structural and cultural forces and still cannot be considered a comprehensive exploration. The issue of motivation and

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<sup>10</sup> Regulators may be slow to detect deviations from normal price and volume movements.

opportunity differences among individuals also remains unresolved. In addition, she fails to explain the fact that some people may have much greater and more attractive opportunities than others. For example, differences in the opportunity structure for different levels of management, or gender differences<sup>11</sup>, may have strong effects on trust violation.

Generally speaking, an integrated perspective combining opportunity and motivation factors presents a meaningful advance in the explanation of insider trading behaviours. Such a grand perspective, however, does not take us very far in understanding such a multifaceted problem. Motivation and opportunity are just two general factors in explaining crimes. Indeed, the etiology of insider trading is a complex one, which still needs further research. Theorists may need to explore more specific and concrete factors related to opportunity and motivation to better explain the complicated phenomenon of insider trading. We should also try to find more clearly how a specific motivation is linked to a specific opportunity in a given social context. Exploiting existing criminological theories and developing more persuasive perspectives in the context of insider trading will be a protracted affair.

### ***Perspectives on White-Collar Crime and Insider Trading Regulation***

Many theories have been proposed to explain white-collar crime regulation (Vago 1990: 10). The functionalist or consensus theorists argue that, although there are different interests and values in society, law and regulation stand above these differences and reflect a compromise and consensus among competing groups in order to sustain the

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<sup>11</sup> Women tend to occupy less powerful positions within an organization and are more likely to be subject to close supervision. Hence, they generally have less access to inside information and less opportunity for committing white-collar crimes such as insider trading. For a general study of gender and white-collar crime, see Daly (1989: 769-93).

social order (Parsons 1951; Friedmann 1971). As Durkheim (1933[1893]: 81) stated, “We must not say that an action shocks the common conscience because it is criminal, but rather that it is criminal because it shocks the common conscience.” According to the functionalist approach, the state does not represent one particular group over another but enacts and enforces law on behalf of all the public. Functionalist theories have been criticized for their oversimplified explanation of law and lawmaking in a complex society. Conflict theorists of lawmaking argue that different groups may pursue different and conflicting interests. Those groups which have more economic and political power will determine the legal process and outcome, and hence will succeed in having their interests protected by law at the expense of less powerful groups (Chambliss and Seidman 1982).

Conflict theories are divided into the pluralist approach and power-elite approach. The pluralist view of the state was introduced by many pluralist theorists, among whom the most influential is probably Robert Dahl (1961). Pluralists hold that power is divided among different kinds of interest groups in capitalist societies. Any interest group can organize as a pressure group and thereby seek to have its policy preferences reflected in the outcome of legal process. Laws are created by conflict and bargaining among organizations which represent interest groups. The state acts as an honest broker between all these different interest groups. Thus pluralists have reached a similar conclusion to that of functionalists, namely, that “the efforts of competing groups tend to cancel each other out, so that the legislative process ultimately reflects the will of the people and the interest of society as a whole” (Coleman 1998: 94). However, pluralists overlook the fact that most proposed reforms stemming from the efforts of competing groups are never

enacted, and that even the enacted laws still benefit the powerful class more than the lower class (Coleman 1998: 119).

Elitist theorists argue that in reality power is not spread around but is concentrated in the hands of a relatively small group of people (an elite), who control the law-making process (Coleman 1998: 94-95). Two main types of the power-elitist approach are instrumentalist and structuralist theories. The instrumentalist approach is usually associated with the earlier work of Ralph Miliband (1977, 1983) while the structuralist approach is associated with Nicos Poulantzas (1978). According to instrumentalist theorists, law is a state apparatus that serves the interest of the ruling class. The government does not pass criminal laws prohibiting corporate crime and other crimes of the powerful because it does not want to do anything that will jeopardize the interests of that class. Such reluctance is related to the state's reliance on the corporate elite to offer jobs and taxes. On the other hand, lower class offenders are much more likely to be imprisoned even when they commit relatively minor street offences (Quinney 1974: 12). Many analysts find the instrumentalist position on lawmaking problematic. McLaren, Menzies and Chunn (2002: 8) note that the instrumentalist view "is unproductive and myopic because it disregards the manifold ways in which lives are subject to social control in both public and private spaces beyond the purview of the state." Friedrichs (1996: 248) argues that the instrumentalist perspective does little to explain white-collar crime laws, because it is "difficult to reconcile with many laws that appear to work against the immediate interests of major capitalist corporations."

Structuralist dialectical theories, on the other hand, view law and regulation not as a direct tool of the powerful class, but as a process aimed to resolve a variety of structural

contradictions and conflicts in society in a certain historical context (Chambliss and Courtless 1992: 37; Poulantzas 1978). According to this perspective, in a capitalist society, law is used to maintain the long-term interests of the capitalist system and control members of any class who pose a threat to its existence. In this view, not all white-collar crimes would be punished. Only those which constitute a threat to the existing political order are criminalized and sanctioned by law.

For many socio-legal scholars, the structuralist view of lawmaking provides useful explanations of many white-collar crime laws. For example, James W. Coleman (1994: 94-120) argues that most of the laws creating white-collar crimes are the product of the interaction between the efforts of consumers, workers, or the general public to limit abuses of the elite, and the response of the elite to such movements. The same class conflicts can also be seen in the enforcement process, for example, in the success the elite have had in weakening the enforcement of legislation that threatens their interests or their use of law enforcement as a tool to suppress the political activities of their leftist critics. In this second struggle, elite interests are in an even stronger position than they are in the legislative arena. Despite the elite's power to manipulate the media (see Gramsci 1971), the political process is far more open to public view than the enforcement bureaucracy, and the voting power of the masses may help to counter the political influence that inevitably flows from vast concentrations of wealth and power. However, the popular appeal of reformist movements is of considerably less strategic significance than the wealth and power of elite groups in influencing the enforcement process. Another source of conflict lies in the struggle among the numerous interest groups characteristic of industrial society (see Vold 1958). And elite groups are themselves divided by conflicting

economic interests. The conflicts between the major stockholders in savings and loan institutions and their high rolling executives are an obvious example. Therefore, although the laws defining white-collar crimes have diverse historical origins, all of them can ultimately be traced back to the dislocations and conflicts caused by the growth of industrial capitalism.

Szockyj (1993) presents a slightly different power-based explanation of lawmaking and law enforcement in her study of insider trading regulation in the US. She agrees with Hagan's (1980) view that "for the most part, powerful interest groups did not contribute significantly to the process" (1993: 32). Hagan and Szockyj both note that reformers or moral entrepreneurs<sup>12</sup> play the decisive role in the lawmaking process, and that those moral entrepreneurs receive personal or occupational benefits for the creation of criminal law. In her study of insider trading regulation in the US, Szockyj (1993: 32) regards the SEC officials as moral entrepreneurs, and argues that their motivation to criminalize insider trading and pursue it as a top priority was to increase the Commission's reputation. Szockyj (1993: 25-28) also notes that there was no organized opposition to insider trading regulation from corporate insiders, because insiders could achieve greater benefits by supporting insider trading laws and thus encouraging investor confidence in the market.

It can be argued that Szockyj's position falls within the structuralist perspective. On one hand, it seems against the interests of corporate and financial elites for insider trading to be criminalized. Yet, on the other hand, by focusing so much attention on

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<sup>12</sup> American sociologist Howard S. Becker (1963: 147-163) coined the term "moral entrepreneurs" to describe "those highly committed individuals who take it upon themselves to disseminate their views to the public and to make sure that their own version of right and wrong becomes law for all."

insider trading and on a few high-profile offenders, the SEC may have avoided dealing with much more fundamental and profitable practices in the securities industry. No matter how vigorously they are enforced, the laws against insider trading do not seriously affect the underlying structural foundations of capital, nor do they really level the playing field between financial and corporate elites and the rest of us, between the haves and have-nots.

This debate on class interest has also been reflected in different perspectives on the rationale for insider trading regulation. Some economically oriented scholars, who usually represent the interests of the corporate sector, argue that regulating insider trading is wrong. The supporters of insider trading assert that insider trading is a constructive form of compensation for entrepreneurs or managers and thus makes the market more efficient. Manne (1966: 127-129) argues in *Insider Trading and the Stock Market* that insider trading is a sort of compensation scheme for entrepreneurs who produce information, and believes that long-term investors will not be hurt by the practice. The entrepreneur is vital to the development of the corporation and must be encouraged to continue to produce information. Otherwise he or she will “disappear from the corporate scene” (1966: 129). Another pro-insider trading argument suggested by Manne is that insider trading speeds the information flow by incorporating information into the price of securities. Manne argues that there is a discrepancy between the market price and the true value of securities before the disclosure of inside information. Allowing insider trading enables insiders to bid up the price in the case of good news and therefore helps to move the price to its proper level more rapidly than would otherwise be the case. No significant harm to long-term investors can result from insider trading, because long-term investors

are much less likely than short-swing share traders to sell due to price changes caused by insider trading (1966: 77-110).

Manne's arguments are obviously welcomed by many economists (for example, Carlton and Fischel 1983: 857), yet criticized by regulation advocates.<sup>13</sup> For example, Kraakman disagrees with Manne's observation that insider trading presents a compensation device. He states:

The evidence is overwhelming that top managers retain enormous discretion over compensation and job tenure in American corporations, subject chiefly to the informal constraints of industry norms, adverse publicity, and the outside risk of a shareholder suit or a take-over. The likelihood that this discretion would be exercised if managers were permitted to profit from low-visibility insider trading would allow managers and other insiders to extract large rents at the expense of the corporation or the market (Kraakman 1991: 53).

Kraakman (1991: 51) also argues against Manne's second justification for insider trading, and points out that allowing insider trading will not promote disclosure, but only enable insiders to hide or manipulate information, because they want to trade on non-public material information for their profits. Loss and Seligman (1991: 340-66) have provided empirical evidence to show that insider trading does not have a major effect on market price, and therefore is not an efficient device to smooth stock price.

Unlike those who focus on market efficiency, many legal scholars, criminologists, and other social scientists generally condemn insider trading and support insider trading regulations. The justification for regulating insider trading has revolved around issues of fairness, market confidence and fiduciary responsibility.

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<sup>13</sup> See the debate between Tomasic (1991) and Dempsey (1996).



As Szockyj (1993: 2) notes from her historical analysis, the classical argument against insider trading is that it is inherently unfair for a person to use confidential information acquired by virtue of his or her special status to trade to the detriment of the other party, who is ignorant of the existence of the information. Allied to this principle is the argument that insider trading is inherently immoral. The clamour for insider trading regulations in the 1920s and 30s hinged on fairness arguments. Some of the advocates of these arguments, while realising the obvious economic benefits of allowing insider trading, contended that such benefits do not outweigh the gains to be realized from ensuring fairness in the securities market (Schotland 1967: 1438).

Although the above arguments still find currency with a few scholars (Heller 1982; Yang 1997), most researchers argue that immoral acts cannot automatically be translated into illegal and criminal behaviours.<sup>14</sup> Such fairness arguments are probably used as a specious cloak of legitimacy to mask the theoretical difficulties of insider trading regulation in some jurisdictions. A pertinent question is: whose morals are the regulations supposed to protect? Notions of fairness and morality are as disparate as there are interest groups to serve.

Another favourite argument of pro-regulators is that insider trading destroys the confidence of investors in the securities market (Tomasic 1991: 60-67). When trading on confidential information is outlawed, investors will trade with the confidence that stock prices reflect their actual value. The proper basis for regulation is, therefore, the need to preserve the expectation of fairness needed to maintain investors' confidence in the securities market.

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<sup>14</sup> For a general analysis of the relationship between legal reasoning and moral philosophy, see Ronald Dworkin (1977).

However, this argument is not supported by any other empirical evidence. What little data there is points to the contrary. In many cases, the agitation for insider trading regulation did not come from investors or the business circles, but rather regulations were foisted upon the investors by reformers or moral entrepreneurs who wished to advance their personal or occupational fortunes (Hagan 1980, as cited in Szockyj 1993: 32). In many countries, it is remarkable that most of the suits have been brought by the regulatory agency that promulgated them. It can be argued that it is not insider trading that destroys the confidence of investors but the noise generated from attempts to enforce the regulations.

Some authors argue that insider trading based on privileged information is a breach of the fiduciary obligations owed to the company. It is further said that allowing insider trading will lead to a conflict of interest in that insiders will be more interested in inventing and shielding information upon which they can trade than in concentrating on the business of the company. By using the phrase “wayward capitalists,” Shapiro (1984: 2) argues that insider trading and other offences in securities markets are essentially the violation of trust. She maintains that “Trust - the impersonal guarantee that ... fiduciaries are not self-interested - is truly the foundation of capitalism” (Shapiro 1984: 2). Based on this assumption, she advocates strong enforcement of securities laws to deter such illegality.

When an officer of a company trades on information belonging to that company, he or she breaches his or her duty not to exploit corporate information for his or her own benefit. That issue is now beyond doubt and it is adequately covered by the common law, but a fiduciary concept does not justify most of the regulations. Sometimes the

information upon which the insider trades comes to him or her in a capacity separate from his or her insider status. Indeed the information may not belong to his or her corporation. Again, most times insiders participate in the share of other corporations, and because they do not owe these corporations any fiduciary obligations, they are not caught under the insider trading rules. In addition, many of the individuals with inside information may be members of professional Self-Regulatory Organizations (SROs)<sup>15</sup>. If there is an offering or a takeover in the works, many lawyers, accountants and their assistants may be privy to inside information. The extension of the regulations to outsiders is not justified by the fiduciary concept. Liability should be based on an abuse of confidence (Strickler 1985: 494, 496).

There is a resistance among regulation advocates against the idea that insider trading is a victimless crime. Tomasic (1991: 67) argues that “in an insider trading transaction there is a party who loses value from the securities involved or is forced to take a loss.” Thus he prefers viewing insider trading as “a crime with an unknowing victim” (1991: 67). Shapiro (1984: 34) also identifies victim populations in her study and finds that they were mostly individual stockholders at the time of victimization. Szockyj (1993: 126) acknowledges the existence of victims, but on the other hand she argues that “[t]rades occurring on the exchanges are impersonal; the identity of neither the buyer nor the seller is revealed.” Her argument is probably more compelling and practical than Shapiro’s.

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<sup>15</sup> Non-government organizations which have statutory responsibility, technical expertise and resources to regulate activities of their own members (corporations, retail businesses and professionals) through the adoption and enforcement of rules of conduct for fair, ethical and efficient business or professional practices. In the context of the present study, the SRO includes any national and provincial stock exchanges, registered securities associations, registered clearing agencies and depository institutions.

McVea (1993: 59-62) adopts a combined approach, which may reconcile the tense debate between regulation proponents and opponents. He argues that fairness, market confidence, and economic efficiency should all be considered before an appropriate model of regulation is adopted. To achieve fairness and market confidence, he advocates formal regulatory measures to serve “the long-term interests of society” (McVea 1993: 62). To attain temporary market efficiency, he also argues for a self-regulation system such as the Chinese Wall, which is aimed at stopping the flow of information from one department in a corporation to another. But he does not explain the meaning of long-term social interests and their relationship with fairness and market confidence. He seems to divorce temporary economic efficiency from social interests, a position which may cause difficulties. Nevertheless, his approach may better reflect the market reality and provides the inspiration for future research.

Different perspectives on rationales for regulation lead to different perceptions of the law and enforcement and different reform proposals. The following section attempts to sort through the literature on the law and enforcement of insider trading.

### ***The Effectiveness of the Law and Enforcement***

The general trend in our expanding and increasingly complex market society is for regulation to grow, since harmful forces with economically undesirable consequences can develop to threaten individuals and communities unless the state intervenes. However, among proponents of regulation, there is an ongoing debate on the effectiveness of existing government regulatory agencies and the best model of regulation to deal with insider trading.

For example, in the US, the Securities and Exchange Commission was established in 1934 as one governmental response to the massive stock manipulations, insider trading offences and frauds that contributed to the 1929 stock market crash. The SEC is an independent agency composed of five commissioners who have been given broad responsibilities to regulate the securities markets (Shapiro 1984: 4). Shapiro observes that a reciprocal relationship prevails between securities offences and their detection by the SEC. She states that “the social organization of illicit activities determines the way they are detected and, therefore, that different strategies of intelligence catch different kinds of securities offences” (1984: 167). Once offenders are detected, the SEC deals with them in administrative, civil or criminal proceedings, according to different features of the offences. Shapiro notes that the SEC closes 47 percent of cases without taking any formal legal action. In those cases where it does initiate formal legal action, the SEC rarely refers cases to the Justice Department for criminal prosecution.

Shapiro is partly satisfied with the SEC’s performance as a “symbolic guarantor” (Shapiro 1984: 190). She asserts that people in the securities business credit the SEC with playing a very important role in restoring a good measure of investor confidence in the market (1984: 190), and that the SEC’s action as a “vigorous and terrifying David in a universe of Goliaths is truly astounding,” given its limited personnel and funding (1984: 192). Although she suggests that SEC intelligence is “passive, haphazard, and fortuitous”(1984: 172), she proposes that existing strategies be expanded and fully exploited and that new intelligence strategies be adopted to increase the SEC’s effectiveness. A mixture of disclosure mechanisms, examination of artifacts, direct

observation (when potential violators can be narrowed down), and spin-offs was advocated by the author to improve intelligence.

Shapiro is much concerned with the need for stronger government support to this regulatory body, politically, morally and financially, to help refine the enforcement process. To protect trust, she asserts that all kinds of violations should be subject to SEC enforcement. Although she implies that self-regulatory organizations are useful for social control, her emphasis on formal regulation is obvious.

Although Shapiro's work is an impressive foundation for more careful and systematic empirical research on enforcement practices, her study is theoretically limited because it does not explore how the SEC relates to the larger social, legal and political context. Unlike Szockyj (1993), for example, Shapiro does not examine the interaction between the SEC, defendants and the courts.

Based on her analysis of the role of power played by the legislature, the SEC and the courts, in shaping insider trading law and enforcement, Szockyj (1993) implies that the SEC is the strongest agency in criminalizing insider trading through legislative and judicial means, but in practice "has achieved only limited success in its attempts to penetrate the secrecy inherent in insider trading" (1993: 55). Echoing Hagan's view, the author also regards the SEC as a "moral entrepreneur" and a milestone in the history of insider trading law (1993: 32). However, unlike Shapiro, she criticizes the SEC's impetus to focus on insider trading cases in the 1980s for reasons of reputation and power achievement, rather than for the protection of investors. She also argues that the vast majority of insider trading cases are detected by referrals from the SROs or informants, rather than by the SEC itself. In addition, Szockyj (1993: 35-54) criticizes discordant

judicial attitudes towards the offence of insider trading. Possession theory,<sup>16</sup> the fiduciary-duty-to-shareholders theory, and misappropriation theory<sup>17</sup> each had supporters among judges, though the SEC's misappropriation theory had been upheld most recently in the *US v. O'Hagan* case in 1997. Although the author is not satisfied with the formal regulatory agencies, she does not provide a clear alternative model of insider trading regulation.

Tomasic (1991: 5-30) is even less satisfied with the effectiveness of the regulatory processes in Australia. Both case law and interviews showed that insider trading laws were not adequately enforced. Tomasic discusses the difficulties that the regulatory agencies had in their attempts to detect and prosecute insider trading cases. The number of insider trading prosecutions was very low, although a substantial number of alleged insider trading cases had been identified by the stock exchanges and the regulatory agencies. At the time of his study, not a single prosecution had been successful in Australia. The reasons could be that: 1) the accused were not guilty; 2) there were insufficient prosecution resources or inappropriate distribution of resources; 3) the prosecution was inept; 4) judges and magistrates were conservative; 4) it was difficult to obtain evidence; 5) the law was unenforceable (1991: 18). Tomasic (1991: 125) argues that "the lack of any successful prosecutions seems to have led many in the industry to believe that the enforcement of the laws is not meant to be taken seriously." Therefore, he

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<sup>16</sup> According to possession theory, insider trading liability requires trading while in "knowing possession" of material nonpublic information, or proof that the trader "used" the information in trading.

<sup>17</sup> Under the misappropriation theory, if an individual misappropriates secret information and trades on it, it is illegal because the person has breached a trust or duty, even if the individual is not a traditional company insider.

calls for a single national prosecutorial agency to take responsibility for insider trading prosecutions.

More recently, a few Canadian scholars also expressed similar concern about the scarcity of prosecutions of insider trading in Canada (McNally and Smith 2003). After investigating the insider trading cases pursued by provincial securities commissions from 1980 to 2002, they conclude that on average less than one insider trading case a year has resulted in a conviction since 1980, although there is large-scale evidence of insider trading offences. McNally and Smith (2003: 138) argue that the inefficacy of insider trading laws may relieve insiders' fear of prosecution and punishment.

Canadian scholars have a different concern about insider trading regulation from their US counterparts. In contrast to the USA's federal regulation through the Securities and Exchange Commission (SEC), the Canadian federal government has played a much more limited role in regulating securities markets. Although the *Canadian Companies Act* of 1934 borrowed from the American regulation to emphasize the principle of full disclosure to investors, it did not borrow insider trading provisions and did not create a national independent regulatory agency like the SEC. On the other hand, the provincial securities commissions have assumed the major responsibility for insider trading enforcement under the provincial securities laws since 1966 (when substantial insider trading law was created) (Johnston and Rockwell 1998). In fact, the provincial securities commissions do take an active role in investigating insider trading and other illegal practices.

Having reviewed the current Canadian regulatory system, Johnston and Rockwell (1998: 245-302) assert that the major problem of Canadian securities regulation is that a



provincially fragmented securities regulatory system leads to duplication and inefficiencies. They argue that the current Canadian Securities Administrators (CSA), which focuses on harmonization rather than uniformity, is not able to solve the problem. Therefore they have analyzed the 1979 proposals for a national regulator, the 1994 revival of the idea, and more recent discussions of the issue. For both constitutional and practical reasons, the more effective regulatory model, in the authors' view, is a uniform national regulator exercising jurisdiction entrusted by both the federal and provincial governments, which is similar to the SEC in the US. Nonetheless, they admit that their national regulation proposal is contrary to the existing political relationship between federal and provincial jurisdictions.

Jeffrey G. MacIntosh, a law professor from the University of Toronto, expressed similar concerns. Considering the fact that the provincial securities commissions are divided on the idea of a national securities commission,<sup>18</sup> MacIntosh notes that the federal government may not have the right to pre-empt provincial regulators, and that “without pre-emption, a national regulator is dead as a doorknob” (2003: FP15). He also argues that “a decentralized system both permits and encourages innovative thinking, and supplies the laboratories in which to test new ideas” (2003: FP15). MacIntosh is in favour of the so-called “passport” system, “in which regulated entities are subject to a single regulator, and all other jurisdictions agree to abide by that regulator's laws and decisions” (2003: FP15).

There is still a voice for a national securities regulator in Canada today. The federal Wise Persons' Committee (WPC) reported to the federal Minister of Finance on

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<sup>18</sup> While the Ontario Securities Commission supports a national regulator, its counterparts in Quebec, Alberta and British Columbia do not.

December 17, 2003.<sup>19</sup> It recommended that the federal government enact a securities legislation creating a single Canadian Securities Commission. Michael Phelps, chairman of the Wise Persons' Committee states, "The Wise Persons Committee has made a signal contribution to solving the single most important problem faced by Canadian capital markets - our fragmented regulatory system. The committee has produced a strong, clear, unanimous set of recommendations on what needs to be done" (Cordon 2003: B7). The WPC's proposal has been supported by Finance Minister Ralph Goodale. However, the provincial Ministers of Finance continue to examine a provincial passport system and

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<sup>19</sup> The Wise Persons' Committee (WPC) was established by former federal finance minister John Manley to review the current securities regulatory system and to recommend an appropriate regulatory structure. The Committee's report, titled "*It's Time*," asserted that the present provincially based regulatory structure served Canada adequately in the past, but has become outdated today, with increasing nationalization and internationalization of capital markets. The Committee listed three major structural limitations of the current system, including "1) inefficient allocation of resources, 2) coordination difficulties in multijurisdictional proceedings and 3) unjustified variation in enforcement priorities and statutory protections for investors." Therefore, the WPC called for the creation of a single, federally constituted regulator built on a joint federal-provincial model. The WPC model suggested that a nominating committee be formed consisting of thirteen people represented by the provinces as well as issuers, intermediaries and investors. The nominating committee would present names to the Minister of Finance from which the Minister would select the commissioners of the Canadian Securities Commission (CSC). The CSC would administer a single statute, a federal act based on the Uniform Securities Legislation (USL), recently released in draft for public comment. Such a federal securities act would not be amended unless a majority of the provinces agreed. The CSC's head office would be located in the National Capital Region. Regional offices would be established in Vancouver, Calgary, Winnipeg, Toronto, Montréal and Halifax. For the full WPC report, see [http://www.wise-averties.ca/reports/html/E\\_Final/index.html](http://www.wise-averties.ca/reports/html/E_Final/index.html).

reject a national regulator.<sup>20</sup> More recently, a number of commentators have indicated that a single national securities commission is unlikely. Many of them argue that a single monopoly regulator fails to accommodate special local needs and may become a bureaucracy-heavy, Ottawa-driven system (Macintosh 2004: FP15; Salman 2004: FP15; Corcoran 2003: C7; Baines 2003: D5). Some observers state that there is no evidence that a national regulator would be more efficient and less costly than the current structure, and that such a regulator will serve the interests of large public companies instead of public investors (MacDonald 2004: B1BRE; Johnstone 2004: B8Fro and 2004: D4). Joe Oliver, chief executive of the Investment Dealers Association of Canada, stated that if provincial finance ministers and regulators do not agree on a solution within a year after the next federal election, “nothing will happen for a long time” (Oliver 2004: FP05).

### ***Self-Regulation of Insider Trading***

Some scholars have also examined the effectiveness of self-regulation to deal with insider trading. Self-regulation is a unique device to regulate white-collar crimes.

The most popular argument in favour of self-regulation is that the SROs have more

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<sup>20</sup> The provincial ministers’ steering committee (Alberta, Manitoba, British Columbia, Saskatchewan, Ontario and Quebec) which is advocating a passport system within the existing structure, prepared a discussion paper in June 2003, titled *Securities Regulation in Canada: An Inter-Provincial Securities Framework*. The paper discussed a number of problems existing in the current regulatory system and some of the actions that have been taken to date. In this paper, the committee concluded that being subject to oversight of more than one regulator can result in unnecessary compliance costs and an inefficient administrative structure for the operation of Canadian capital markets. The committee believed that the passport system would enable market participants to access all participating provinces/territories (known as “host regulators”) simply by obtaining authorization from the regulator in their home province/territory (known as the “primary regulator”). The central concept of a “passport system” is that regulatory decisions made by an authority in one jurisdiction are recognized by the authorities in other jurisdictions. In effect, the successful applicant would be granted a “passport” that would be recognized in the other jurisdictions. The committee asserted that the passport system would be relatively simple to implement and could be adopted in a timely manner as it builds on the existing regulatory structure and mutual reliance review system. It can meet local and regional capital market needs in innovative ways. The committee stated that a concrete action plan for the establishment of the passport system would be submitted by September 30, 2003. However, such a plan has not yet been publicized to date. The full discussion paper is available at [http://www.revenue.gov.ab.ca/publications/securities\\_regulation/securities\\_discussion\\_paper\\_english.html#2](http://www.revenue.gov.ab.ca/publications/securities_regulation/securities_discussion_paper_english.html#2).

expertise and resources to regulate activities of corporations and professions (Friedrichs 1996: 298).

McVea (1993) proposes a co-regulation model combining formal regulation and informal regulation based on market realities. After comparing UK and US laws against insider dealing, he finds that formal regulation can deter offenders from breaking down Chinese Walls, while self-regulatory measures like Chinese Walls can "provide further incentives to trade fairly" (1993: 121). McVea looks at the Chinese Wall as a suitable self-regulatory mechanism of preventing insider dealing and other conflict-of-interest abuses in today's financial conglomerates. He asserts that the Chinese Wall can alleviate conflicts of interest more generally and efficiently than other instruments. Based on a series of special policies and procedures, the Chinese Wall is "an essential back-up to formal statutory ... controls" (1993: 134). He maintains that since the Chinese Wall is an effective policy instrument for preventing insider dealing and other abuses of conflicts and has been increasingly approved by the USA and the UK legislators and regulators, the exact position of the Chinese Wall needs to be resolved to meet the needs of the new market practices.

McVea's model seems to have echoed Reichman's (1989) integrated regulatory approach, although the latter is more concerned with excessive government intrusion and invasions of privacy. Recognizing investment bankers' conflicting roles as trustees and entrepreneurs, and that "controls must be consciously built into existing [market] relationships" (1993: 199), McVea suggests that an integrated model of both formal and informal control may keep up with the market development (1993: 199).

Tomasic (1991: 139) claims that insider trading law reform cannot be successful if it is based on "a philosophy of minimal legislative intervention in this industry." He argues that the self-regulation regime is unlikely to be effective in dealing with insider trading in Australia. Lack of confidence in self-regulation, conflicts of interest, inconsistent enforcement of listing rules, and limited jurisdiction are the main barriers to such a regime. Although he argues for "a system of co-regulation," he asserts that the self-regulation structures can function only as "an essential line of first defence against fraudulent practices in the industry" (1991: 97).

As shown by the above review, the regulation of insider trading encounters many challenges that are less likely to arise in response to conventional crime. Both formal regulatory agencies and self-regulatory organizations face various difficulties in times of financial diversification. A co-regulatory model is probably more effective since it can better adapt to today's market situation. But how to integrate the two different regulatory forces in the appropriate way is still an open question, in need of more research.

### ***Summary***

The studies discussed in this chapter have raised some interesting questions as to the research methods, the etiology of the offence, the rationale of regulation and the law, and its enforcement. Many of the findings by various researchers on insider trading in different jurisdictions are very informative and instructive. The review shows that we need to recognize the strengths inherent in the diversity that already exists. Shapiro (1984: 71) has suggested that a combined methodology be used for insider trading studies, which may help to eliminate the limitations of each method. Motivation and opportunity represent two of the factors, among many, which cause insider trading

offences, although more factors need to be explored by future researchers. McVea (1993: 59-62) has proposed a more comprehensive rationale for insider trading regulation, which covers fairness, market confidence, and economic efficiency. His and Reichman's co-regulatory models (McVea 1993; Reichman 1989) may better suit modern market economies and democratic societies. However, studying insider trading may be more complicated than supposed. In every jurisdiction, there have been only a limited number of socio-legal studies dealing with insider trading and law enforcement. Furthermore, I have not attempted here to undertake an exhaustive literature review of insider trading studies all over the world. It is premature to claim that these studies of insider trading and regulation correspond with the reality of insider trading in all countries. There is an urgent need for cross-national comparative studies of insider trading and its regulation.

## **CHAPTER THREE: RESEARCH DESIGN**

### ***Introduction***

The central question of this dissertation is: How are insider trading laws enforced or not enforced by the securities commissions in Canada and China? This question examines the differences and similarities existing between insider trading laws' enforcement in the two countries.

There are five clusters of sub-questions: 1) How have the definitions of insider trading and sanctions against it developed through the two jurisdictions' enforcement decisions? Is insider trading a priority for the commissions? 2) What actions have been taken towards those accused of insider trading? How do the staff of the securities commissions in the two jurisdictions gather, process, and control the information that leads to crucial decisions on whether and what to prosecute, and whether to proceed administratively or criminally? What is the most frequent method of disposal of insider trading cases and why? What are the motivations for the Commissions to investigate and prosecute? 3) Is there any difference of actions between lower status and higher status offenders? Is there any difference between individual and organizational insider trading offenders? To what degree are the staff's actions influenced by the nature of various insider trading offences and the status of offenders? 4) What are the major challenges and problems in enforcement in the two countries? In what circumstances will the Commissions give up investigations and drop charges? 5) What lessons can China learn from the Canadian insider trading laws for its future law reforms and vice versa?

In order to gain an understanding of insider trading laws and enforcement in the specific social and political contexts of the two nations, my research methodology involved a triangulation technique (Denzin 1970: 300-301; Flick 1992: 175-197; Glaser and Strauss 1978: 53-57), by which multiple data sources with similar focuses were sought to obtain diverse views about the topic. The goal of the research and the choice of methodology determined that the research would be rooted in a socio-legal analysis of insider trading regulation in the two jurisdictions of Canada and China. The socio-legal approach that is adopted here needs a brief presentation.

### ***Socio-Legal Research***

Instead of the traditional approaches of lawyers that focus on how to read and understand statutes, regulations and cases in a pragmatic and eclectic manner,<sup>21</sup> socio-legal research treats law as a social phenomenon and aims to reveal social meanings of law and social relations reflected by the process of law-making and enforcement. Therefore, socio-legal scholars are particularly interested in social processes through which legal reality is produced and reproduced (Harvey 1990: 2-4). The present study focuses on the actual implementation of insider trading laws in the two countries. In other words, the major concern is with the operation of regulators and the procedures through which insider trading laws take meaning both for them and for those under their regulation.

The socio-legal approach is also contrasted with positivist criminology which claims to observe phenomena objectively and to predict and explain causal relations among key variables, in order to prevent crime or catch criminals (mostly from the lower

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<sup>21</sup> There is an increasing interest in studying law from a socio-legal perspective in law schools and social science departments today.



class) through assisting the criminal justice agencies to develop better programs (Brockman 2003: 288; Harvey 1990: 1). Socio-legal research attempts to explain law and legal process through incorporating the insights of the state, law, social control, resistance, moral regulation and governmentality and integrating the various levels of social analysis into a meaningful whole (McLaren, Menzies and Chunn 2002: 4-19). To conduct an in-depth analysis of white-collar crime and regulation, socio-legal scholars seek to “provide insights into the broader organizational and institutional dimensions of the problem” (Edelman 2002: 2, as quoted in Brockman 2003: 291).

The notion of contradiction is encoded in a socio-legal analysis. This approach sees the process of law and regulation as a struggle between competing groups striving to enact and enforce laws favourable to themselves. It views fundamental change of law emerging from the fact that movement comes through contradictory forces acting against each other, creating an unstable situation. In her study of the Italian Worker’s Rights Laws of 1970, Calavita (1986: 191) outlined the nature of critical-dialectical methodology of law:

Law is seen not as the product of a monolithic state structure but rather as the outcome of contradictory political and economic forces. Furthermore, once formulated, the implementation, enforcement, and outcome of law are subject to similar series of conflicts. In other words, law is but one component of a dialectical process that both precedes and follows it. This process is fired by contradictions not only in the economy but also in the state itself. Therefore, while economic and class contradictions limit the potential impact of state action, political contradictions (within the Italian party system, for example) limit the extent to which the state can realistically be viewed as a single action pursuing monolithic interests.

From a socio-legal perspective, insider trading laws and enforcement in post-communist China and Canada have evolved through contradictory social and political

forces. Many interest groups have tried to influence the content of those insider trading bills and worked to prevent or promote their enforcement. Even neo-liberals would admit the existence of conflicts of interests in enacting and enforcing laws (McVea 1993). New laws were normally the products of pressure from specific interest groups, with little significant opposition. It can be argued that the power to enforce insider trading laws, to a large degree, depends on judges' and regulators' ideological and institutional legitimacy within such a social network. Judges and regulators normally interpret insider trading acts subject to the reality of social, political and economic relations, and not necessarily according to the real intention of the law. As Lon Fuller (1968: 17) observes, "By the words of the Code the act is criminal, but judged by the realities of official behaviour the act escapes any effective legal restraint."

Socio-legal research emphasizes the need for empirical data collection and investigation. Official documents, other textual data, directly observed behaviour, interview responses, or any other method can be useful for a socio-legal study, as long as they can provide insights into the social phenomena in question. But whatever they are, the phenomena "must not be taken at face value" (Harvey 1990: 7-8). Data are meaningful only in terms of their theoretical context (1990: 7). Reliability and validity are merely functions of the context and the epistemological perspective that the researcher brings to the research. Therefore, data are important to ground the research "but data must not be treated as independent of their socio-historic context" (1990: 8). As Marx suggested, revealing the real state of affairs depends on a thorough detailed empirical observation and analysis of actual social practices (Burns 2000: 94).

Socio-legal researchers of white-collar crime and law, then, may benefit from using an integrated approach combining the examination of official data and legal cases, interviews, and analysis of newspapers and periodicals. It is more valid to integrate different methods to fully understand such crimes and laws in their wider social context. This dissertation therefore enlists socio-legal methods to the usual data collection processes such as in-depth interviewing and documentary review to elaborate an understanding of the nature of insider trading laws and enforcement under analysis. I started with historical documents, statutes, legal cases, news articles and other documents, and asked myself questions like “why is the law and enforcement of insider trading like this?”, “why has this historically been the case?”, and so forth. From there I broadened the enquiry by designing interview questions and searching for more documentary evidence. This process involved a shuttling back and forth between insider trading law enforcement and its historical and social background, and between documents and interviews.

In sum, what binds the socio-legal community is an approach to the study of which is multi- or inter-disciplinary. Socio-legal scholars undertake library-based theoretical work and documentary data collection, empirical work which supplements analyses of legal documents, as well as more policy-orientated discussions which are expected to feed directly into the policy-making process.

### ***Data Sources and Collection Methods***

Given its nature described above, this dissertation is intended to analyze the underlying legal doctrines, principles, and public policies of insider trading regulation, the fundamental values that are embodied in law and, above all, the social context where

the law is made, enforced and changed. I have made use of a multitude of sources to study insider trading regulations in the two countries. Often facts gained from textual data, such as statutes, court and administrative rulings and reports, were verified and complemented by in-depth interviews.

### **Contents and Compilation of Textual Data**

The material on which most of the dissertation is based was acquired from the following textual materials:

- Historical documents on the development of insider trading laws in Canada and in China. The relevant historical accounts of insider trading laws in media, documentary materials and periodicals in the two countries were analyzed.
- Statutes, their revisions and amendments. Attention was paid to China's *Constitutional Law*, *Company Law* 1994, *Securities Law* 1998, *Criminal Law* 1997, and the relevant supplementary statutes enacted in the post-1979 period, as well as some of the key statutes regarding securities regulation made before 1979. The Canadian statutory documents reviewed include the *British North America Act*, the *Canadian Charter of Rights and Freedoms*, the *Securities Acts* of Ontario and British Columbia, the *Criminal Code* of Canada, and other relevant statutes regarding insider trading in Canada.
- Insider trading policy statements, administrative hearings, decisions, orders, proposals, memoranda, press and other releases, media coverage,

and other relevant publications of securities regulatory bodies in the two countries.

- Other relevant official documents. I reviewed a number of statements of the Chinese Communist Party, central and local governments, political leaders' speeches and other government documents related to the securities markets and securities regulation in China. I also looked at relevant national and local policy statements and other official documents in Canada.
- Treaties, directives, agreements and other international documents to harmonize or coordinate securities regulations.
- Books of authority and secondary materials. I reviewed Chinese and Canadian securities law textbooks, criminal law textbooks, white-collar crime books, journal articles, conference papers and other publications on securities law, criminal law, white-collar crime, and insider trading. I also looked at media reports on securities regulation and white-collar crime (insider trading in particular) in the two countries.
- A limited number of relevant documents in some jurisdictions other than China and Canada were also reviewed for comparative purposes.

My visits to public and private libraries and university libraries from November 2001 to March 2004 provided access to newspapers, periodicals, books, several government publications and secondary materials regarding white-collar crime in general and insider trading in particular in Canada and China. I have visited Simon Fraser

University (SFU) Library, the University of British Columbia (UBC) Library and the University of New Brunswick (UNB) Library, as well as three major Chinese libraries - Beijing Library, Beijing University Library and East China Normal University Library. I have also obtained relevant materials from other Canadian university libraries through SFU's Interlibrary Loan system.

The Internet sources were widely employed to access statutes, policy documents, administrative cases, orders, proposals, memoranda, news releases, media coverage, journal articles and other relevant publications in the two countries. Treaties, directives, agreements and other international documents were also found by the Internet search. Sites used extensively include the websites of British Columbia Securities Commission (BCSC), Ontario Securities Commission (OSC), Alberta Securities Commission (ASC), Canadian Securities Administrators (CSA), International Organization of Securities Commissions (IOSCO). The Internet also provided a means for accessing electronic databases, newspapers, magazines and journals. Canadian Newsstand (including materials from 1985) and CBCA Full Text Reference (including materials from 1982) were the two major sources of media reports covering insider trading in Canada. Due to the possible incompleteness of relevant information in the electronic news databases (especially the lack of news information before 1982 in the databases), I also conducted a manual search on microfiche for newspapers like the *Globe and Mail*, the *National Post* and the *Financial Post* at the SFU Library. Canadian Periodical Index, Lexis-Nexis, Criminal Justice Abstracts, Humanities & Social Sciences Index, Index to Canadian Legal Literature and SocioFile were also used to locate materials needed for this dissertation.

The most convenient way to search for the variety of cases in Canada needed for this research was to use Quicklaw. The Quicklaw databases cover a number of administrative and court cases, statutes, journal articles, newsletters and other useful materials regarding insider trading in Canada, under the subject of “securities regulation.” My key word search of “insider trading” and reading of the cases and other documents proved that it was a successful way to generate the cases and other materials of interest, although it was a very time-consuming job. Another way to discover insider trading cases and other useful documents was to search the websites of the securities commissions under study. Annual reports of the commissions which were available on their websites provided very useful information on insider trading cases. These searches were particularly important in trying to find cases and other documents that are not held by the Quicklaw databases.

Since Quicklaw and many other electronic tools do not include any information regarding insider trading cases, statutes and other documents in China, I looked for these materials through the Chinese Securities Regulatory Commission (CSRC) website, Chinalawinfo.com (owned by Peking University), as well as published law books and reports, newspapers, magazines, and journals that I bought from bookstores in China for my research. Based on the above sources, however, it was still very difficult to obtain the full records of Chinese insider trading cases and other relevant documents, because there is no official legal case reporting system in China. In-person visits to the CSRC headquarters in Beijing and its branches provided access to the CSRC internal publications. These publications provided valuable insights into the exercise of discretion

by the commission. Details were extracted from 120 internal reports between 1992 to 2003.

Since there was not a large number of insider trading cases in Canada or China, I did not draw a sample, but collected and analysed every case within the chronological periods I could access through the data sources. I coded the emerging cases as I collected them (see Appendix B). For each case, data on the province and/or country of the case, identity of the parties, the type of case, the amount of funds involved, the major issue(s) involved, the outcome, the time to disposition, whether it went to appeal (and the appeal outcome), media coverage, and other key information was extracted from the case files and other related sources. The data were entered manually onto coding forms. Through this coding process, I started to define and categorize the data. I engaged with the data and posed questions about them while coding them, in order to present a better reconstruction of insider trading enforcement in the two countries. The deconstructive-reconstructive process grounds conceptualisation in the material world, and involves a constant exchange between abstract concept and concrete data (Harvey 1990: 29). Therefore, questions such as “what can be inferred about the politics of enforcement from the cases” frame the enquiry. From the data, I attempted to explore how the enforcement institutions regulated insider trading.

Memo writing was used as the intermediate step between coding and the first draft of the completed textual analysis. Memo writing aided me in linking analytic interpretation with empirical reality. I incorporated raw data of cases and documents into memos so that I could maintain those connections and examine them directly (Strauss and Corbin 1990: 249-258). In certain cases, I encountered some background questions



in the process of memo writing. At this point, I looked for information to supplement the original case data.

In sum, I adopted an ongoing cyclical process of organizing the textual data into categories and identifying patterns among the categories: 1) searching documentary data; 2) coding topics, classifying topics, and developing them as categories (I attached keywords or symbols to segments of data to permit later retrieval, kept data in an organized database, connected relevant data segments with each other, wrote reflective commentaries on some aspect of the data as a basis for deeper analysis, and formed categories); 3) seeking patterns (themes/concepts) among categories; and 4) comparing, analysing and interpreting themes, and developing the analysis (Denzin and Lincoln 2000: 18-23; Huberman and Miles 2000: 782-783).

### **Interview Data**

Recognizing the dangers in concentrating upon literature readings, and I decided to go beyond the existing documents and conduct semi-structured and unstructured interviews to obtain first-hand empirical data on the actual practice of insider trading law-making and enforcement. Interviews were intended to supplement textual data by allowing the regulators to voice their perceptions and explanations of insider trading enforcement.

Prior to the commencement of the formal interviews, I selected a strategic sample from the British Columbia Securities Commission (BCSC), the Chinese Securities Regulatory Commission (CSRC) headquarters in Beijing and its Shanghai branch, and drafted an interview protocol from March to August 2001, aiming to reflect various

perceptions and ideas about insider trading regulations in Canada and China. The sample of 16 prospective interviewees was composed of four commissioners or hearing officials (two from the BCSC, two from the CSRC), three executive directors (the BCSC executive director, the CSRC executive director and the CSRC Shanghai branch's executive director), three enforcement directors (the BCSC enforcement director, the CSRC enforcement director and the CSRC Shanghai branch's enforcement director) and six staff members who were in charge of insider trading investigations (three from each nation). The protocol design was based on discussions with my senior supervisor, insider trading researchers, previous research on insider trading and white-collar crime (Shapiro 1984; Tomasic 1991; Szockyj 1993). My professional experience as a former prosecutor of commercial crime cases and a lecturer and researcher in the Chinese Prosecutors' College for four years in Shanghai proved helpful for my research in China, because this working experience, although limited, is crucial to the understanding of insider trading regulation in China. Field notes from my own observation and publications on securities offence cases during my term as a prosecutor (1993 to 1997) were also used as a starting point for designing interview questions. Most of the interview schedule consisted of open-ended discussion questions that were to be analysed by qualitative methods (See Appendix E). The research protocol was provided to my dissertation advisory committee for comments and improvement.

Questions varied between interviews depending on the different categories of prospective interviewees, although some overlapping questions were designed to generate ideas and perceptions about the same issues from different groups. Questions for the commissioners of the securities commissions were:

1. Do you see illegal insider trading as a major problem for securities regulators in your jurisdiction?
2. Do you think that illegal insider traders should be dealt with severely? Why or why not?
3. What are the major problems faced by securities regulators in investigating illegal insider trading and enforcing insider trading laws?
4. Is there anything the Commission can do to enhance or improve its ability to better deal with insider trading problems?
5. Are you aware of how insider trading is dealt with in China [Canada]? Do you think China [Canada] could learn anything from Canada [China]?

Besides the above questions, the following three specific questions related to enforcement processes were designed for the executive directors, the enforcement directors and staff of the securities commissions:

- (1) Could you estimate the percentage of time that your investigators and enforcement staff spent on illegal insider trading over the past two years?
- (2) On what basis do you make the decision on whether to proceed with any investigation of alleged insider trading offences? What evidence do you need to build an illegal insider trading case? How do you find the evidence?
- (3) I have looked at the insider trading cases from your commission in the last 15 years. (For British Columbia Securities Commission) It seems that you have only managed one successful administrative prosecution for insider trading, i.e., Doman/Bennett case. (For China) It seems that there has been no successful criminal prosecution for the particular offence of insider trading so far. Did I miss anything? What factors do you take into consideration when deciding whether or not to charge and prosecute an insider trader criminally or administratively? What type of insider trading offenders are caught and are involved in administrative proceedings and criminal proceedings? Any difference between these two types of offenders?

Right after I received ethical approval of my protocol from the Simon Fraser University Research Ethics Committee in December 2001, I flew to China and started to locate and contact members of the above-selected sample. Although I acknowledged possible difficulties in locating and interviewing the members of the sample especially in China (due to China's poor reputation for suppressing freedom of research), I did not anticipate major problems impeding the interviews with Chinese securities regulators. Part of the reason for my optimism was ascribed to the fact that the Chinese government has vowed to fight against insider trading and would likely welcome more research on such a topic. In addition, as a former Chinese prosecutor, I was well acquainted with many securities regulators in the CSRC Shanghai branch. Some chief regulators in Shanghai were also former prosecutors. I was aware of which persons to interview, how to get access to them and how to conduct effective interviews with them.

However, my research in China did not go as smoothly as I had expected. Indifference, distrust and hostility represent the common attitudes toward my presence at the CSRC. Many friends who worked in the commission voiced enthusiasm and support for my research in the first instance, but became indifferent when they learned about my topic. A few of the CSRC officials in Shanghai with whom I am familiar warned that asking questions about insider trading enforcement was very risky, and tried to persuade me kindly to change my dissertation topic to a less sensitive one, such as "a general review of the Chinese securities legislation" (Interview with the CSRC Shanghai branch hearing officials, December 2001). Some staff members refused my requests for personal interviews. The CSRC officials were primarily concerned about violation of so-called state secrecy that might bring them trouble. China's definition of state secrets is very

broad and it can encompass virtually any information not specifically approved for publication.

To get more assistance for my interviews, I accepted a temporary lecturer position at the law school of Shanghai Jiao Tong University (SJTU). Fortunately, I was able to locate and interview several major CSRC officials in Shanghai with the help of some former colleagues, friends and professors at SJTU. The first interviewee was the director of the hearing department in the CSRC Shanghai branch. During the two-hour interview, he provided very rich information about insider trading enforcement in both the branch and the headquarters in Beijing with his answers to my questions and copies of some internal documents.<sup>22</sup> The number of enforcement officials available to discuss insider trading enforcement in China began to expand through their referrals. Having used this snowball sampling technique, I located and interviewed the enforcement director of the CSRC Shanghai branch and two enforcement staff members. These interviews proved invaluable for complementing the documentary analysis.

However, my first visit to the CSRC headquarters in Beijing in late December 2001 was not fruitful. I was stopped outside by four paramilitary Chinese armed police officers guarding the CSRC building. When I showed my SFU student identification and told them the purpose of my visit, one police officer directed me to the reception window, where I was told to fax my request to the CSRC general office for approval. On the same day, I sent my formal request including an introduction of myself and the research, an invitation to participation for the enforcement director, the executive director,

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<sup>22</sup> He did, however, call me in the evening before I left for Canada and warned me: “please do not take the documents with you to a foreign country. Otherwise you might be in trouble and may also get me in trouble.” To respect this caution, I scanned the documents and saved them in my SFU webmail, with his permission, and returned the original copies, so that I could still use them when I was back in Canada.

commissioners and staff members, the research protocol, an informed consent form, as well as my postal address, telephone and cellular numbers and email address. I waited for two weeks in Beijing, but received no response.<sup>23</sup> A professor at SJTU, who was a former CSRC legal counsel in Beijing, suggested that I might contact his personal friend, the CSRC Vice-Chair and chief accountant. With the professor's referral, I eventually conducted a one-hour interview with the Vice-Chair, who provided general information about the CSRC enforcement of insider trading and arranged for my interview with the enforcement director. Through the CSRC Vice-Chair's referral, I also interviewed a senior judge of the Supreme People's Court of China. However, the Vice-Chair and the enforcement director both expressed reluctance to introduce me to the commissioners and staff members.

Another valuable interview was with Professor Gu at Shanghai Social Sciences Academy, who is a leading expert in the Chinese securities regulation, a drafter of the new securities legislation and an advisor to the CSRC. Professor Gu was very open about addressing the law-making process, but still reticent to discuss his knowledge of specific on-going cases at the CSRC, although he admitted that he was able to access information concerning these cases. His information was nonetheless very helpful to the history chapter of the dissertation.

It was somewhat easier to conduct interviews with the Canadian securities regulators because of the more transparent enforcement systems in this country. I gained access to individuals at the British Columbia Securities Commission through my senior supervisor, Professor Joan Brockman. Through her referral, the BCSC executive director

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<sup>23</sup> Actually I have never received any reply from the CSRC general office.

and a Vice-Chair agreed to participate in July 2002. Interview times and dates were set by email with them. Another prospective interviewee, the enforcement director, did not respond to my email request.

I encountered friendliness, openness and cooperation during the course of these interviews. I also had an opportunity to read documents, reports and memos provided by the officials with whom I had spoken. Given the focus of the dissertation, the two interviews seemed sufficient to supplement the textual data related to the enforcement of insider trading regulations in Canada. Therefore, I suspended my efforts to locate and contact other prospective interviewees.

During the period from December 2001 to July 2002, I conducted eleven interviews in total, with members of the securities commissions in the two nations and a few professors and judges in China. Interviews took place in interviewees' offices for their convenience. While most of the interviews were one or two hours in duration, the two longest interviews took three hours each. It was emphasized that the participants were free to discuss issues beyond the protocol which they felt were important and that they did not have to answer the questions they chose not to address. In the vast majority of cases, there were no refusals to answer specific questions. However, one Chinese respondent refused to answer the question "Do you see illegal insider trading as a major problem for securities regulators in your jurisdiction?" Another Chinese interviewee was unwilling to talk about the basis on which the commission staff made the decision about whether to proceed with any investigation of alleged insider trading, and what evidence they need to build an insider trading case.

Interviews with Chinese respondents were conducted in Chinese in order to reflect their original meanings. I then translated these transcripts into English. Each interview was undertaken face-to-face by the researcher. The interviews were tape recorded with the permission of interviewees in Canada, and in China notes were taken.<sup>24</sup> At the completion of each round of interviews, the records from each interview were transcribed, checked and translated by myself and prepared for analysis. I individually analysed every interview I conducted, and then arranged the interview data into the following categories for each nation: law-making, detection, investigation, administrative proceedings and criminal proceedings. Finally, I selected and presented passages which could specifically supplement my analysis of textual data in the dissertation.

### ***Significance of the Research***

As I mentioned before, there are still very few critical empirical studies of white-collar crime in general, and insider trading in particular, both in China and the West. In most jurisdictions, the existing empirical literature tends to focus on street crimes. Critical social research on white-collar crime has tended to be dominated by theoretical and legal treatises in both China and Canada. This dissertation will address the prior absence of critical empirical studies of insider trading crime and its legal regulation, by comparing how the enforcement apparatuses of the Securities Commissions in British Columbia and China work. Furthermore, a study of insider trading politics in the context of a post-communist society in China will provide an opportunity to understand how a one-party authoritarian system deals with the relationship between market economic development at one end and white-collar crime control at the other. This work adds to the

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<sup>24</sup> All the Chinese participants asked that the interviews not be tape recorded, but allowed me to take notes instead.



academic literature in the field of comparative critical social studies of white-collar crime in Western jurisdictions. The integrated approach of research methods within a critical perspective will contribute to a methodological framework for further socio-legal research into insider trading and other white-collar crimes. Finally it has potential significance for China's law reform initiatives, and for Canadian financial and legal cooperation with China. Therefore it is anticipated that this project will generate a great deal of interest, not only among academics and policy makers, but also among the general public.

### ***Limitations of the Research and Ethical Issues***

There are several limitations to this study. The basic problems during the field research are twofold. First, inadequate research funding for travel and other costs have limited my data collection and thus restricted my research coverage and depth. Second, I encountered a selective survival of documents and a political construction of historical events. For a variety of reasons, some of the archival documents are missing from libraries and official documentary centres. Some amount of time was thus needed to track down missing materials. Furthermore the available records are written from the perspectives of authors whose ideological angles may inform their recording and analysis.

Ethical issues are intrinsic to socio-legal research, as implied by the intent to erode ignorance and misapprehensions, and to take full account of values and historical situatedness in the inquiry process. Thus there is a moral imperative that the researcher be revelatory rather than deceptive (Guba and Lincoln 2000, in Denzin and Lincoln 2000:115). It is essential that the researcher anticipate many of these possible ethical

dilemmas beforehand. These dilemmas can take place in an obligation of trust and confidentiality between the researcher and individual respondents, institutions and the state.

For each case, I informed the interviewee that participation is voluntary, and that he or she may discontinue participation at any time. I also asked for permission to record or take notes in each interview. I identified the prospective readers of the dissertation and explained to the participants that they could decide what information should not be published. I also obtained their permission for the use of their comments as quotations. Before I left each interview, I told the interviewee how to get in touch with me later if he or she wanted.

The clearest concern in the protection of the participants' interests and well-being is the safeguarding of their identity. If revealing their behaviour or responses would injure them in any way, adherence to this norm becomes all the more important. The imperative of confidentiality assists the researcher in this regard. In any event, subjects should be assured that information they provide will be used for research purposes only.

In my case, the major individual respondents were the enforcement officials of the Securities Commissions. Respondents were assured that their identities would remain confidential if they wished. As soon as possible, all names and addresses were removed from data-collection forms and replaced by identification numbers, except in the case of reported cases. A master identification file was created, linking numbers to names to permit the later correction of missing or contradictory information. This file was kept in a safe place in my house. It was destroyed at the conclusion of the project. I also asked for the participants' permission to use their titles in my dissertation. Three of the

interviewees expressed no objections to the use of their names, but I have not used their names.

### *Summary*

This chapter has provided an overview of my research methodology and process. In sum, a combination of textual analysis and interviews was used to gain a comprehensive view of the historical, socio-economic, political and legal influences on insider trading laws in Canada and China. The use of a combination of different research techniques was a productive means of reducing the problems associated with the shortcomings of each individual method. Silent documents were supplemented by and compared with more vivid records of conversation and observation. These techniques complemented one another and removed the sources of error that a single method entails (see Harvey 1990; Creswell 1994; Mason 1996).

Findings from the textual and interview data are presented in the following three chapters. I use these data sources to develop a socio-legal analysis of insider trading law and enforcement in Canada and China. Chapter 4 discusses historical developments of insider trading laws and current legislation in the two nations. Chapter 5 addresses my findings on insider trading cases in Canada. Chapter 6 discusses the findings on Chinese insider trading cases. The final chapter compares the findings on the two countries' insider trading law enforcement.

## CHAPTER FOUR: HISTORICAL DEVELOPMENT OF INSIDER TRADING LAWS IN CANADA AND CHINA

### *The History of Canadian Insider Trading Laws*

The first provisions relating to insider trading in Canada were the fairly elementary sections in the 1934 *Dominion Companies Act* that required disclosure of directors' interests,<sup>25</sup> which were not directly related to subsequent legislative efforts in this area. However, the regulation of securities markets is primarily a matter of provincial responsibility.<sup>26</sup> The early provincial securities legislation was very similar to the early American blue sky law<sup>27</sup> in that the laws in both countries were aimed at preventing

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<sup>25</sup> Section 95 of the *Dominion Companies Act*, 1934, required every director of a Dominion company, other than a private company, to submit annually to the company's secretary at the annual general meeting, at the request of shareholders, a report showing all transactions in any of the company's shares by him or her or for his or her own account during the year preceding the meeting. This provision was inadequate because the shareholders had to request such an annual report and it was not filed in the form of a register. Section 96A(2) forbade directors to speculate for their personal account in any of their company's securities. Failure to comply with this provision constituted a criminal offence with a fine of \$1000 and/or six months' jail term. There had been no criminal prosecutions under this provision, partly because it was hard to define the vague term of "speculation." It is doubtful whether this provision really had any substantial impact on insider trading laws. The draftsman most probably intended to forbid short swing speculation by directors whether or not on the basis of inside information. See Section 95 and 96A(2) of the *Dominion Companies Act*. For a discussion of the *Dominion Companies Act*, 1934, see Williamson (1960: 17-20) and Smalls (1935: 52).

<sup>26</sup> Under Section 91 of the *British North America Act*, the provincial governments were given powers which included the regulation of property and civil rights. Provincial securities laws have been upheld even where there is some overlapping, but not conflicting, federal law. For a discussion of the conflict between the provincial and federal governments with respect to the regulation of trading in securities, see Anand, Johnston & Peterson (1999: 27-28).

<sup>27</sup> Blue sky or "state securities" law is the body of laws and rules developed by each state in the United States to ensure that its residents were protected when they made investments. Issuers, broker-dealers, investment advisors and agents of each are regulated in the respective states in which they conduct their business. Thus, offers of securities made into or from a particular jurisdiction are regulated by that jurisdiction. The stated justification for these state securities laws was to prevent the sale of fraudulent securities, particularly to unsophisticated investors. While the Securities Exchange Commission began in 1933, the first blue sky law was enacted in Kansas in 1911 after fraudulent promoters were selling pieces of

fraudulent acts in the issue of corporate securities (Williamson 1960: 20-28; Armstrong 1997: 63-72). Trading on the basis of inside information had technically been illegal in the United States since the 1930s (Szockyj 1993: 5). Canada, however, had no such prohibitions until 1966.

Major efforts toward the regulation of insider trading in Canada were made with the publication of a series of official reports during the early 1960s, when the wave of corporate mergers and acquisitions across North America had sparked concerns that insiders were profiting unduly from takeovers at the expense of ordinary shareholders (Royce 1970: 359-371).

The poor reputation of the Canadian securities markets during this time was commented on by the Ontario Securities Commission Chair J. R. Kimber: "There is nothing in our legislation which prohibits an officer of a company from distributing inside information. Nor is there anything improper in a person receiving such information from acting thereon" (Armstrong 2001: 224).<sup>28</sup> Thus takeovers raised new questions for Canadian provincial securities regulators. Should restrictions be imposed on corporate insiders to prevent them from using privileged material information on securities trades for their own profits?

### **The Kimber Report**

The most significant step forward in the regulation of insider trading in Canada came with the publication of the *Report of the Attorney General's Committee on*

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paper backed by nothing more than that of clear "blue skies". This is how the name came about. Between 1911 and 1931, 47 of the 48 states adopted blue sky laws. See the discussion in Loss and Cowett (1958: 276).

<sup>28</sup> PAO, AG, 4-02, file 220.1 Provincial Secretary John Yaremko to AG Frederick Cass, 13 February 1963; file 219.3, Memorandum from Kimber to Cass, 5 September 1963. As cited in Armstrong (2001).

*Securities Legislation in Ontario* (the Ontario Kimber Report), named after the chair of this committee. In October 1963, the Attorney-General of Ontario appointed the Kimber committee to examine and report on securities regulation in the province and, in particular, “to consider the problems of take-over bids and of insider trading and the degree of disclosure of information to shareholders...”(*Kimber Report*, 1965: 1). After its thorough investigation, the Kimber committee recognized the importance of fostering investor confidence and recommended the introduction of insider trading provisions similar to those contained in Section 16(a) of the United States *Securities Exchange Act* 1934 (Rider & French 1979: 118). The *Report of the Ontario Royal Commission on the Investigation into Trading in the Shares of Windfall Oils* (1965) also found substantial evidence of insider trading and criticized the Ontario Securities Commission and the Toronto Stock Exchange for their ineffective market regulation.<sup>29</sup>

However, there was little agreement in debate about what regulations were needed in this area. For example, some members of the Toronto Stock Exchange were in favour of allowing insider trading and argued that such trading activities might push stock prices in the right direction and thus make the market more efficient. The majority, however, noted several negative effects of insider trading and pushed for disclosure of such trading acts (Ontario 1964a, September, as cited in Armstrong 2001: 231). Most witnesses who appeared before the Kimber committee believed that anti-insider trading regulation would be necessary. David Grenier, financial editor of the *Telegram* in Toronto, asserted that the vast majority of people blamed insider trading for introducing unfairness into stock markets. The Canadian Bar Association (CBA) also argued for legal prohibition of

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<sup>29</sup> See Chapter IX of the Report. The “most shocking incident” of insider trading was committed by John Campbell, the Director of the Ontario Securities Commission, and his wife (1965: 43-50).

insider trading. The CBA Brief (Ontario 1964b, September, as cited in Armstrong 2001: 231) stated:

The unfortunate fact is that insiders ...appear regularly to take advantage of this information ...The only inhibition against abuse is a remnant of social pressure or religious conviction. Some people seem to believe that taking advantage of insider information is like cheating at income tax – only bad when you are caught.

The Kimber committee concluded that insider trading was certainly a problem that needed to be dealt with. The committee held that every investor should be provided “the fullest possible knowledge of all relevant facts for trades. Otherwise, it would lessen the confidence of the investing public in the market place” (*Kimber Report* 1965: 10, Para. 2.02). For the first time, the committee differentiated legal insider trading and illegal insider trading. The *Kimber Report* stated:

In our opinion, it is not improper for an insider to buy or sell securities in his own company. Indeed it is generally accepted that it is beneficial to a company to have officers and directors purchase securities in the company as they thereby acquire a direct financial interest in the welfare of the company. It is impossible to justify the proposition that an investment so made can never be realized or liquidated merely because the investor is an insider. However, in our view it is improper for an insider to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company (1965: 10, Para. 2.02).

The committee considered the existing legislation and case law to be insufficient to protect Canadian investors from insider trading activities. It therefore recommended the enactment of a statutory provision granting shareholders a civil remedy where they suffered loss from transactions with a corporate insider who had used privileged material information. The committee also recommended a provision under which the insider should be liable to his or her company for any profits made by insider trading in its shares

(Kimber Report, 1965, pp. 10-11 paras. 2.21-2.26). In general, these recommendations received favourable comments in the press (Crawford 1965: 400). The meaning of the word “insider” was, however, rather restricted, under the Kimber committee’s approach, partly because the committee worried that a broad definition might have undesired negative effects on the operation of the securities markets. The committee therefore provided a careful definition of the term “insider” which basically referred to senior corporate officers:

The definition should be broad enough to cover those members of management who have access to confidential information and take part in the formation of corporate decisions, but narrow enough to exclude junior officers whether they have access to such information or not (Kimber Report, 1965, pp. 10-11 paras. 2.21-2.26).

The committee recognized that professional advisors, such as lawyers and accountants, must assume a role in ensuring the health of the securities market, but should be subject to self-discipline enforced by the relevant professional organizations (Crawford 1965: 403; *Kimber Report*, 1965, p.12, para. 2.09).<sup>30</sup> It is arguably a major defect in the *Kimber Report*, because relatively looser regulation of such self-regulatory bodies would undoubtedly be insufficient in deterring their members’ insider trading.

The *Kimber Report* also controversially excluded “persons not connected with the company, but connected in some manner with the insider, such as spouses, relatives, friends and business associates...” (*Kimber Report*, 1965, p.12, para 2.12). The secretary to the Kimber committee stated:

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<sup>30</sup> The relevant professional bodies do forbid insider trading and the misuse of confidential information in their rules, for example see Rule 2(a) of the Canons of Ethics of the Law Society of Upper Canada and Rule 36 of the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario.



[T]he purpose of the *Kimber Report* in this area was to achieve a fair measure of equity without too great a loss of precision ...To include tippees in the liability provisions might well have, at this stage in the development of our law, created undue uncertainty as to the concept of improper trading, a concept at the moment in the embryonic stage of its evolution (Crawford 1965: 410).

Although the Kimber committee recognized the fact that many insiders had improperly employed their position to profit from takeover arrangements, it is surprising that the committee did not consider that the anti-insider trading laws should extend to the circumstance where an insider trades the shares of a company other than his or her own (*Kimber Report*, 1965, p. 18, para. 2.32).

### **Section 113 of the 1966 Ontario Securities Act**

The recommendations of the *Kimber Report* were enshrined in the Ontario *Securities Act*, 1966. The provinces west of Ontario followed almost immediately with uniform legislation that practically duplicated the Ontario legislation. These provinces include Alberta (The Alberta *Securities Act*, 1967), British Columbia (The British Columbia *Securities Act*, 1967), Manitoba (The Manitoba *Securities Act*, 1968) and Saskatchewan (The Saskatchewan *Securities Act*, 1967).

Section 113(1) of the Ontario *Securities Act*, 1966 provided that:

[e]very insider of a corporation or associate or affiliate of such insider, who in connection with a transaction relating to the capital securities of the corporation, makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of such securities, is liable to compensate any person or company as a result of such transaction, unless such information was known or ought reasonably to have been known to such person or company at the time of such transaction, and is also accountable to the corporation for any direct benefit or advantage received or receivable by such insider, associate or affiliate, as the case may be, as a result of such transaction.

An insider was defined to include directors, senior officers and 10 percent equity shareholders of a corporation [Section 108(1)(c)]. The term associate was defined in section 2(2). Where the term was used to indicate a relationship with any person or company, it meant any company of which such a person or company beneficially owns, directly or indirectly, equity shares carrying more than 10 percent of the voting rights attached to all outstanding voting equity shares of that company at that time [Section I(2)(i)]. The term also included partners of the person or company, acting by or for the partnership in which both he or she and the insider are partners [Section I(2)(ii)], and any trust or estate in which such a person or company had a substantial beneficial interest, or in relation to which he acts as a trustee or in some similar capacity. Finally, some observers argued that a spouse, a child, apparently whether emancipated or not, and any other relative of the insider “who has the same home” as the insider should be considered as an associate (Gillen 1998: 80-84).<sup>31</sup> An affiliated company is a company that is a subsidiary of that other company or a company under the same control as that other company.<sup>32</sup>

The scope of the insider trading prohibition received much criticism on the grounds that it did not include persons who, although in an “access relationship” to the company, were not directors or senior officers or substantial shareholders (Johnston 1968: 199).<sup>33</sup> Furthermore, mere tippees were also excluded from the definition.

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<sup>31</sup> Section I(2)(iv) and (v). Thus trading by an insider’s son, of any age, is covered; trading by his wife would not unless she shared the same home as her insider father-in-law.

<sup>32</sup> For the definition of subsidiary and holding companies see Section I(25)(4) and (5), and for the concept of control see Section I(25)(3)(a) and (b).

<sup>33</sup> The Canadian rejection of the access test is, of course, one of the main differences between the United States of America’s approach and the Canadian approach (Johnston 1968: 199).

Alberta, British Columbia, Manitoba and Saskatchewan had a similar provision as section 113(1) of the 1966 *Ontario Securities Act*. It should be noted that these provincial securities statutes of the late 1960s did not consider insider trading as an offence under the enforcement provisions and hence did not provide for administrative or criminal sanctions for insider trading.

### **Green v. The Charterhouse Group Canada Ltd**

There were very few prosecutions under section 113(1). The only reported judicial decision was the judgement of *Green v. The Charterhouse Group Canada Ltd* (1973).<sup>34</sup> This judgment sketched out some important interpretive criteria for the novel insider trading liability provisions. The plaintiff, Green, had been a director, senior officer and a substantial shareholder of Imbrex Ltd, a federal corporation. The plaintiff and certain other shareholders had an agreement that he would offer his shares to them before selling them on the market. All these parties were insiders of Imbrex, according to Section 108(1)(c) of the 1966 *Ontario Securities Act*. The plaintiff thought that the market price of Imbrex would probably decline, and decided to sell 20 percent of his shares. He complied with the agreement, giving the other parties notice of the quantity and terms that he offered for such sale of his shares. The other shareholders under the agreement refused to accept the offer, so the plaintiff sold these securities on the open market. After the plaintiff had ceased to be a director of Imbrex he decided to sell out completely and gave notice again to the other signatories in accordance with the agreement. Shortly before the sale, however, the other shareholders knew of the possibility of a take-over offer on favourable terms, and at a substantially higher price per share than what the

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<sup>34</sup> See Johnston (1973: 676-690) for comments on this case.

plaintiff was offering to sell for. Nevertheless, the parties to the agreement refused to accept Green's terms and made a counter-offer at an even lower price. The plaintiff accepted this and concluded the transaction. On the materialization of the take-over, the shares of Imbrex rose in price.

The plaintiff brought a civil action under section 113 against the other shareholders under their agreement and claimed that he was entitled to recover his loss. Mr. Justice Grant of the Supreme Court of Ontario held that the defendants were not liable on all grounds. The major part of Grant J.'s 85-page judgment is a discussion of the evidence and findings of fact. The analysis of applicable legal principles is, by contrast, brief and therefore confounding.

Grant J. interpreted the term "insider" in a rather restricted way and did not consider Imbrex to be an insider of itself, or an affiliate or associate in that sense. This observation is open to doubt, because Imbrex was technically an associate of at least two insiders, both of whom beneficially owned over 10 percent of its securities. In deciding one of the disputed transactions, the learned judge also controversially decided that a corporation which made a large purchase of the plaintiff's securities could not be considered an insider, since prior to the transaction it had not been a 10 percent shareholder in Imbrex.

The courts in the United States, on the other hand, did consider a company in such transactions to be an "insider" under Section 16(b) of the *Securities Exchange Act* 1934. The trial judge also ignored the fact that the purchasing corporation was at that time an associate of at least two insiders. Cranston (1974: 179) asserted that this might "be

evidence ... of a reluctance on the part of the judiciary to bring corporate personalities within the liability provisions of the Act.”

Grant J. decided that a Canadian court should interpret Section 113 in “plain and ordinary meaning” (at 735). However, many observers argued that the Canadian Courts would have regard to the vast experience of the United States of America in applying this law, but Grant J. rejected United States precedent<sup>35</sup> on the grounds that the American common law differed materially from the Canadian law. He concluded that “our court ought not to rely on American case law under Rule 10b-5 as a guide to the interpretation.” This approach has been criticized as being far too narrow (Johnston 1973: 681). The essential concepts in insider trading regulation are the same throughout the world (Rider 1977: 764). The Court also took a restrictive approach to the Kimber Committee Report, stating that it could not be used to decide what objectives the legislature had in enacting the provision, but only to see what evil the legislature intended to remedy (Johnston 1973: 680-681).

To create liability under Section 113, Grant J. emphasized:

... it is only an insider, associate or affiliate who makes use of specific confidential information for his own benefit who attracts liability of the section. It would be an unreasonable interpretation to hold that because an insider of a corporation by his acts has subjected himself to liability under the section, that therefore any or all of his associates or affiliates ... should be automatically affected... (at 736).

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<sup>35</sup> According to the judgment of the United States case of *SEC v. Texas Gulf Sulphur* (1968), mere possession of material inside information at the time of trading was sufficient to constitute insider trading under Section 10(b) and Rule 10b-5 (the two United States federal securities statutory liability provisions impinging on insider trading). Accordingly, trading by either corporate insiders or their tippees was prohibited unless the information on which the trades were based was released to the public.

According to this approach, if an insider commits insider trading for the benefits of his or her spouse, relatives or friends, he or she will be relieved from any legal liability for such trading. This judgment arguably provided large loopholes for corporate insiders.

In a vague observation, Grant J. stated that “once it is proven an insider buys from one who has no knowledge of the events that constitute ... specific confidential information, then an onus of explanation devolves upon him to establish that he did not make use of the information” (at 736). However, it is unclear from this holding whether the plaintiff must prove the existence of specific confidential information and, presumably, that he had no knowledge or could not reasonably have been expected to have had such knowledge before the burden passes on to the defence. Rider and French (1979: 122) have argued that this standard only obliges the plaintiff to prove the existence of specific confidential information, and therefore merely the allegation that he did not know or have the means of knowledge should be sufficient to pass the burden.

Grant J. also considered the question of what constituted “specific confidential information.” The judge held that the information should be confidential to the company, either belonging to the company or acquired by the company for its corporate purposes. This interpretation certainly reflected the intention of the Kimber committee and the legislature to deal with those instances where corporate fiduciaries have betrayed their corporate trust. It is unclear, however, whether market or outside information was included in this category. Some scholars previously argued that the “specific confidential information” need not necessarily have emanated from the company in the first place (Williamson 1960: 361).

The judge also accepted that the requirement of “specific” information related to the question of certainty. Grant J. stated:

In considering whether a director has been guilty of a breach of trust in relation to an insider transaction, one must differentiate between a knowledge and expertise developed through experience or financial sophistication about the company or the market of its shares from facts or information which are available to all the parties involved and a knowledge of specific events or the probability of future events gained through the directors’ access to the corporate business or activities which are not available to other parties with whom the director is dealing, or to the public generally. The latter case is inside information. The former only points out the special ability of the director which he is entitled to use to his own benefit and need not pass on the advantage thereof to the shareholder with whom he deals (at 740).

Grant J. held that while the information of the possible take-over in the present case was “confidential,” it was not “specific,” because he considered that the information was of a preliminary and uncertain nature. Grant J. went even far to hold that the information in question need not be disclosed under the Toronto Stock Exchange’s timely disclosure policies.

Most controversially, Grant J. held that the defendants had not made use of the information complained about for their trades. The judge accepted the defence that the insiders were reluctant to acquire the plaintiff’s shares, and that they had to purchase to avoid the shares being thrown on the market with the resulting disturbance to the value of such shares. Furthermore, the transaction had been in the context of a mutually beneficial agreement between the plaintiff and the defendants. The plaintiff had himself commenced the negotiations. The judge held that, based on the evidence, the insiders did not purchase the shares with the information in mind or with the intention of making a profit by using such information. He emphasized that some insiders still retained their securities even at

the time of the trial and those who immediately disposed of them did so at a loss. However, the judge ignored the possibility that those few insiders who retained their shares might have done so when it became clear that the plaintiff might sue them under Section 113. Furthermore, his judgment was not convincing in explaining the linkage between the profits certain insiders made and the take-over information.

Although Grant J. refused to look at the United States law on the question of liability, he did refer to the American cases on the question of damages. He adopted the principles applied by the United States courts in calculating damages, which were set out in the *Reynolds v. Texas Gulf Sulphur* (1970) litigation. Accordingly, he held that the plaintiff had a duty to mitigate his damages and cover himself on the market by replacing his shares as soon as he reasonably could do so after learning of the non-disclosure of which he complained (Rider and French 1979: 122; Williamson 1966: 361-362).

In his closing statement of the judgment, Grant J. showed his favourable attitudes toward the corporate insiders and criticized the plaintiff's suit against them:

He never could have thought that his friend ... was guilty of any wrongdoing in the matter but he persisted in the action ... He challenged the reputation of others who were businessmen of high repute (at 756).

The plaintiff appealed to the Ontario Court of Appeal, which affirmed the decision of the trial judge [*Green v. The Charterhouse Group Canada Ltd* (1976)]. However, the Court of Appeal was of the view that the information as to the state of the negotiations between the board of Imbrex and another company was specific confidential information within the meaning of section 113. Yet the Court of Appeal was persuaded by the evidence that the defendants did not make use of the information in the transaction.



## **Munk and Clairtone Sound Corporation**

Some other cases emerged under Section 113, but very few actually reached the courts, and none, except the *Green* case, were officially reported. Many of these cases were handled by closed-door negotiations and settled with considerable secrecy (No Author 1969: B5). One case that did draw public attention, although it was not reported by the courts and the Ontario Securities Commission, was that involving Clairtone Sound Corporation of Toronto. Founded in 1958, Clairtone was controlled by a Nova Scotia Crown corporation. It had been a successful manufacturer of high fidelity record players and later produced colour televisions. The company released inspiring annual report for 1966 and promised increased profits for investors. However, in the first months of 1967, Clairtone went under despite receiving large amounts of public money from Nova Scotia. Clairtone President Peter Munk and Vice-president David Gilmour quietly sold about 29,000 shares of Clairtone stock in early July, 1967, all at prices between \$9 and \$12, before the damaging financial results of the company were released to the public. The company collapsed, leaving investors with substantial losses (No Author 1969: B5; Dow 1969a: 14).

This case was raised in the Ontario Parliament by the Opposition on June 3, 1969. Dr. Morton Shulman, an N.D.P. member of the Ontario Legislative Assembly, expressed his concern that Munk might escape liability for his illegal trading because the time limitation for launching an action would expire soon.<sup>36</sup> The Ontario Minister of Financial and Commercial Affairs responded that a court order had been requested to require the Ontario Securities Commission “to commence an action [before the expire date] in

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<sup>36</sup> Section 113(2) provided that the action must be initiated within two years of the offence.

connection with Clairtone Sound Company ... for an action in the name of the company for the accounting of profits allegedly made by him [Munk] by reason of the improper use of inside information” (Legislative Assembly of Ontario, Hansard, June 3, 1969; No Author 1969: B5). However, such an action was never commenced against Munk.

A civil lawsuit was filed against Munk in the Supreme Court of Ontario by a Clairtone shareholder named John Adams, who had bought 1,000 shares and lost at least \$8,000. Munk hired Charles Dubin (who subsequently became Ontario’s Chief Justice) to solve the civil action. Dubin was described by Shulman as an experienced lawyer who was “amazingly good at covering up Conservative scandals” (Dow 1969a: 14). According to Shulman, Dubin and Adams’s lawyer reached a \$35,000 out-of-court settlement on Adams’s agreement not to make the case public. Shulman stated that the obvious effect of this “unscrupulous buy-off” was to suppress further claims (No Author 1969: B5; Dow 1969a: 14; Dow 1969b: 14).

The N.D.P. financial critic also alleged that the two lawyers persuaded the judge in the action to remove the papers from the Supreme Court office and keep them in his own private chambers, contrary to standard procedure. By hiding legal papers from the public, the company’s insiders had prevented the case from coming to trial and hindered other stockholders’ efforts to go after Munk. The Ontario Securities Commission was urged to release all the information that it had available on the case, before the limitation period expired (No Author 1969: B5).

On June 10, 1969, the OSC applied for leave to bring an action against Munk and Gilmour on behalf of the company claiming \$799,295 in illicit profits. The Ontario Supreme Court dismissed the Commission’s application and then the case was statute-

barred. This case attracted a widespread criticism by the media and the OSC was criticized for responding slowly. The Ontario Commercial and Financial Affairs Minister admitted that the law against insider trading was “impotent” (No Author 1969: B5).

### **The OSC’s Interpretation of Section 113**

The Ontario Securities Commission (OSC) had an opportunity to determine the scope of insider trading liability under Section 113 in the *National Sea* decision [reported as *In the Matter of Connor et al.* (1976)]. National Sea Products Ltd was a public company listed on the Montreal and Toronto Stock Exchanges, and was Canada’s largest fishing company. Since 1967, National Sea’s earnings had gradually increased. During the first two quarters of the 1974 fiscal year, National Sea’s financial situation was even better than before. In early April 1974, the company’s press release announced that the third quarter would show satisfactory results. However, the third quarter showed a loss of \$592,000. Although the directors received regular operating reports which showed negative financial results, they did not decide to issue a press release until June 26. National Sea’s share price fell from \$15 to \$16 per share in June to \$9.25 per share on July 2. It was alleged that, from June 4 to June 26, six insiders sold a substantial number of their shares.

The OSC analysed the insider trading allegation under Section 113. The Commission had little difficulty in concluding that the information that National Sea would report a loss for the third quarter of the fiscal year was “specific confidential information,” although no individual insider was aware of the exact figures. The Commission referred to Arnup J.A.’s remarks in the appellate decision of the *Green* case and observed that a mere expected loss which was consistent with a publicly-disclosed

forecast would not be considered “specific” or “material.” However, the Commission emphasized that “while it is not possible to be precise as to the meaning of specific, an item of information must be judged in its context to determine if it is sufficiently crystallized, mature and singular to meet the legislative intent” (*In the Matter of Connor, et al.*, 1976, at 151).

It is interesting that the Commission determined the meaning of “specific” primarily from its analysis of “materiality.” It concluded that there could be little doubt that this information “if generally known, might reasonably be expected to affect materially the value” of National Sea’s securities (at 152). The Commission did not refer in this connection to the impact of the press release on the market, but to the short-term decline in price from the \$15 - \$16 per share range to \$9.25 per share. Factors considered in the Commission’s decision in this regard included: whether the insiders of National Sea knew the loss would occur, the 18-month history of record-breaking earnings, the optimistic press release, and the fact that the loss unexpectedly occurred.

Following the *Green* decision, however, the Commission held that there was no evidence that any of the insiders had made use of the inside information in their alleged trading. The Commission admitted that this was an exceptional case and stated (at 152):

It may well be asked how one may trade in securities of a company of which he is an insider with specific confidential information that might reasonably be expected to affect materially the value of such securities without making use of such information. Such cases must indeed be rare, but we feel, on the balance, that this is one such case.

A number of factors appeared to have influenced the OSC in its conclusion that there had been no abuse in this case. Some purchasers were sophisticated investors and had attempted to become major shareholders of National Sea. One purchaser was willing

to treat the purchase as a long-term investment and was not concerned about short-term results. The Commission also found that the purchasers had proactively approached the defendants. However, the Commission ignored the fact that some of the purchasers were completely unaware of the short-term outlook for National Sea and probably would not have purchased at the same price if they had been so informed. The Commissioners, nonetheless, commented that under the United States Rule 10b-5 the insiders would have been liable but added that they “were confined to the terminology of Section 113(a)” (at 153). The Commission admitted that the phrase “make use” in the provision implied a favourable defence for the insiders to get profits from their inside information.

The OSC found that one insider, who had sold 1,000 shares on the morning of June 26 (after the relevant board meeting on the night of June 25 and prior to the press release), did contravene the standard of Section 113. However, the Commission imposed no penalty on him, because it held that the insider in question believed that the press release had been made public by the secretary of the directors’ meeting the preceding night, and “that there was no conscious wrongdoing” on his part (at 154). Nevertheless, the Commission emphasized that “an insider is not in all cases free to trade as soon as a press release with respect to the specific confidential information is put over the Dow-Jones Wire” (at 154). The Commission held that: “the information must be disseminated to the trading public and the trading public must have it in its possession for a period of time that will allow it to digest such information, given its nature and complexity” (at 155). The Commission did not set up firm rules as to what time interval will be appropriate and stated that much will depend upon the content and complexity of the information, the nature of the market, the place of the company’s operations and the place

of dissemination of the news. As a safe working rule, the Commission decided that the insider should wait a minimum of one full trading day after the release of the information before trading. The Commission decided not to take further action against the insiders, because it considered that they behaved honestly in their trading.

It should be noted that, both in *Green* and in *National Sea*, the major reason for the successful defence was the analysis of the “make use” requirement in Section 113. Although section 113(1) set up statutory inhibition on insider trading, with so few cases, neither the court nor the OSC took the opportunity to sufficiently address the problem of insider trading. In British Columbia and Alberta, there were simply no court or administrative cases reported under their similar insider trading liability provisions.

### **Insider Trading as An Offence**

Since insider trading was not considered an offence by the Ontario *Securities Act*, 1966, no criminal penalties were prescribed for insider trading under the 1966 legislation. In June 1970, a Private Member’s Bill was introduced into the Ontario Parliament proposing a fine of \$1,000 for violation of Section 113(1) (Bill 130, 3<sup>rd</sup> Sess. 28<sup>th</sup> Legislative, 19 Eliz. II, 1970). Section 137 of the Bill provided that every person or company that contravened the Act, or a regulation or order made thereunder, was guilty of an offence, and liable to a fine of \$1,000 and/or one year’s imprisonment. However, this Bill did not become official law.

The British Columbia *Securities Act*, 1967 was amended by the *Securities Act Amendment Act*, 1975 and provided in Section 111(1)(b) a quasi-criminal penalty of a fine of \$2,000 and/or one year imprisonment for insider trading offences. This provision

was the only one in Canada creating specific criminal liability for insider trading, prior to the enactment of the Ontario *Securities Act*, 1978. However, I have found no quasi-criminal prosecutions under it from the existing sources.

On September 15, 1979, Ontario *Securities Act*, 1978 came into force, replacing the 1966 legislation. Section 75(1) stipulated:

No person or company in a special relationship with a reporting issuer shall,

(a) purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change in the affairs of the reporting issuer that he or it knew or ought reasonably to have known had not been generally disclosed; or

(b) inform, other than in the necessary course of business, another person or company about a fact or change which he knows is a material fact or material change before the material fact or material change has been generally disclosed.

This Act brought forward the regulatory pattern of its predecessor while stepping up its burden on a number of points. In particular, this Act made improper insider trading an offence (see Alboini 1980: 547-548). Section 118(1) stipulated that:

Every person or company who ... contravenes this Act or the regulations ... is guilty of an offence and on summary conviction is liable, in the case of a person, other than an individual, or company, to a fine of not more than \$25,000 and, in the case of an individual, to a fine of not more than \$2000 or to imprisonment for a term of not more than one year, or to both.

By using the words “special relationship” (Section 75) for the first time in the history of Canadian insider trading legislation, the law extended the insider trading liability rule in two important respects. First, the new insider trading liability rule included in the class of potential defendants those who gain inside information by virtue of any working relationship with the issuer (Section 131; Alboini 1980: 909-910). Thus

the rule went considerably beyond the definition of corporate insiders under the 1966 Act, to include such persons as investment firms underwriting a new issue. Second, the rule covered the tipping phenomenon by making the tipper (but not the tippee) liable (Alboini 1980: 911). Proposals were made to step up the scheme of regulation yet again, by diminishing the time within which insider reports had to be filed and included tippees under the penal and civil liability rules (Bill 176, *An Act to Amend the Securities Act*, 2<sup>nd</sup> Sess., 32<sup>nd</sup> Legis., 31 Eliz II, 1982).<sup>37</sup>

### **Kwinter's 1986 Proposal Regarding Insider Trading Laws**

Since insider trading was considered an offence by the above-mentioned statutes, there was a movement towards increasing insider trading liability in Canada during the 1980s and early 1990s. Major changes to laws covering “insider trading” in the Ontario securities market were proposed on December 11, 1986 by the Minister of Financial Institutions, Monte Kwinter. Kwinter stated (Hansard report, Legislative Assembly of Ontario, December 11, 1986):

We want to see all parties to illegal insider trading held accountable ... Under our proposal, we could prosecute those who receive tips from insiders along with the insiders themselves. The new legislation should catch both ‘tippers’ and ‘tippees’ ... A ‘tipper’ is an insider who, by virtue of being a corporate director, officer, employee, professional or business consultant, has insider information. A ‘tippee’ is a person who receives information from an inside source ... Obviously, the principle we have in mind is that everyone trading in the securities market should have equal access to information.

This proposal, therefore, changed the definition of an offender under the existing insider trading laws. It expanded the definition of an “insider” to include a broader range

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<sup>37</sup> This Bill subsequently died on the Order Paper.



of people who have access to privileged information. It would include persons who learn that a take-over bid is about to take place from a person connected with the offeror, such as an offeror's lawyers, accountant, fiscal agent or printer, and employees of the issuer and persons closely connected with the issuer.

The proposal also increased the penal sanction for insider trading offences to a maximum of \$1,000,000 and/or two years in jail. It established a minimum fine for insider trading equal to the profit incurred by the insider, with a maximum fine of the greater of \$1,000,000 and three times the profit.

To avoid unnecessary delays, this insider trading legislation was proposed as an addition to amendments to the Ontario *Securities Act* – Bill 156, which was already before the legislature for second reading. Kwinter stated (Hansard report, Legislative Assembly of Ontario, December 11, 1986), “In light of concerns raised by a widely publicized case of insider trading in the United States, involving Ivan Boesky<sup>38</sup> and illegal profits in excess of \$50 million, I would like to see this matter dealt with quickly.”

### **Controlling Insider Trading Under the Current Law**

Kwinter's proposal was passed by the Legislature of the Province of Ontario, and was incorporated into the Ontario *Securities Act*, 1990. Section 76 (1) of the 1990 Act provided as follows:

No person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.

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<sup>38</sup> Ivan Boesky, the former stock speculator, was charged with and pleaded guilty to making \$100 million in illegal profits from insider trading. In 1987, Boesky was sentenced to a three-year prison term (but served just under two years) and paid an estimated \$100 million fine.

This statutory prohibition against insider trading is clearly concerned with “special relationship” persons. Hence the definition of this term is crucial to the scope of insider trading prohibition. Section 76 (5) defined “special relationship,” which includes:

- (a) a person or company that is an insider, affiliate or associate of
  - (i) the reporting issuer,
  - (ii) a person or company that is proposing to make a take-over bid, as defined in Part XX, for the securities of the reporting issuer, or
  - (iii) a person or company that is proposing to become a party to a reorganization, amalgamation, merger or arrangement or similar business combination with the reporting issuer or to acquire a substantial portion of its property,
- (b) a person or company that is engaging in or proposes to engage in any business or professional activity with or on behalf of the reporting issuer or with or on behalf of a person or company described in subclause (a) (ii) or (iii),
- (c) a person who is a director, officer or employee of the reporting issuer or of a person or company described in subclause (a) (ii) or (iii) or clause (b),
- (d) a person or company that learned of the material fact or material change with respect to the reporting issuer while the person or company was a person or company described in clause (a), (b) or (c),
- (e) a person or company that learns of a material fact or material change with respect to the issuer from any other person or company described in this subsection, including a person or company described in this clause, and knows or ought reasonably to have known that the other person or company is a person or company in such a relationship.

At a glance, the provisions of ss. 76 (1) and (5) will appear exhaustive especially since they include the typical insiders, their partners and employees as well as their tippees and their tippees’ tippees. Also, given that the wording of s. 76 (5) (e) regards “a person or company that learns of a material fact or material change with respect to the

issuer from any other person or company” as coming within the subsection, the insider trading prohibition is capable of extension to traders who casually, and as a matter of pure chance, have stumbled into unpublished price-sensitive information.

The only group of persons that seems to have been excluded from the classes of persons who may not trade on non-public information are government employees (civil/Crown servants) including those of the securities Commissions. Although the Ontario Securities Commission has considered it necessary to issue directives to its staff members concerning the treatment and use of confidential information which may be given to or filed with the Commission as the administrator of the *Securities Act* provisions (OSC Policy 2.4, 2001), the absence of any specific liability provisions covering these persons means that they are only exposed to the risk of dismissal for “cause” by their public employers whenever their illicit trading activity is discovered. In the face of the notoriously large profits that insider trading is acknowledged to be capable of generating, dismissal could hardly be a deterrent in any meaningful sense.

Section 76 (2) outlines the prohibition against “tipping”. It forbids reporting issuers as well as “special relationship” persons from communicating unpublished price-sensitive information other than in the necessary course of business. This provision goes after mere communication of non-public information whether or not trading results therefrom.

The Ontario *Securities Act*, 1990, made both trading upon and tipping of unpublished material information quasi-criminal offences for which the Ontario Securities Commission is empowered to initiate the relevant proceedings. By the operation of section 122 (1)(c) and sections 76(1), (2) and (3), a special relationship

person who trades or tips is guilty of an offence and, upon conviction, is liable to two years in jail and/or a fine that will be no less than the profit made and may be as high as the greater of \$1 million or triple the profit made. It must be observed again that, in order that quasi-criminal liability may fall on a “special relationship” party who has indulged in tipping, it is not necessary that the tippee should have traded upon the information. As of April 7, 2003 the maximum fine in these circumstances rose to \$5 million and the maximum term of imprisonment rose to five years less a day. Insiders convicted of insider trading will be liable to a fine of not less than the profit made or loss avoided by the illegal trading and not greater than \$5 million (up from \$1 million) and an amount equal to triple the profit made or loss avoided [*Keeping the Promise for a Strong Economy Act* (Budget Measures), Ontario, Amendments to OSA, Section 122(4), 2003].

The broader definition of insider trading and harsher penalties were also adopted for insider trading by British Columbia (BCSC, NIN#89/22) and Alberta. Those who commit insider trading or tipping are liable to the general imprisonment terms imposed by securities legislations in British Columbia and Alberta. In Alberta, the maximum term is five years [ASA, Section 194(2)(b), (4) and (5), RSA 2000, c. S-4]; and in British Columbia, it is three years [BCSA, Section 155(2), RSBC 1996, C48]. The courts can impose fines instead of or in addition to imprisonment. Alberta and British Columbia provided a lower maximum fine penalty than Ontario for insider trading offences - no less than the profit made and may be as high as the greater of \$1 million or triple the profit made. For a tipper, the “profit made” is any consideration the tipper has received for tipping. This amount will often be zero and may, therefore, entail little deterrence or compensatory effect. Johnston and Rockwell (1998: 149) argue for an alternative that

makes the tipper responsible for paying back profits made or losses avoided by the tippee or tippees.

British Columbia allowed the Commission, until recently, to impose an “administrative penalty” of not more than \$100,000 (*BCSA*, Section 162, RSBC 1996, Chapter 418). In May of 2002, the Securities Amendments Act of B.C. increased the administrative penalty to not more than \$500,000 “in the case of a person other than an individual,” and not more than \$250,000 “in the case of an individual.” In Ontario, under the new *Keeping the Promise for a Strong Economy Act (Budget Measures)*, 2003, the OSC is given power to order the payment of an administrative penalty of up to \$1 million, and the disgorgement of amounts obtained as a result of the non-compliance with insider trading laws.

### **The Provincial Securities Commissions and the Regulation of Insider Trading**

In Canada, regulation of the securities industry is carried out primarily by securities commissions, which were created by the provincial securities acts to administer securities law. These commissions are not branches within a government department but rather stand somewhat independent, although still accountable to the provincial Minister of Finance. They are two-tiered in structure. The first level consists of commissioners. The second level consists of a staff headed by a chief administrative officer or executive director (Johnston & Rockwell 1998: 37-38). The commissioners, including the chairperson of the commission, are appointed by the provincial governments. The commissioners make orders and rulings, issue investigation orders, and act as a tribunal for the purposes of hearing appeals from the dispositions of administrators. The securities commissions also formulate policies and make recommendations to government for

changes in legislation or regulations. The executive director oversees the work of the staff who serve the demands of an increasingly complex and active market. The executive director leads the staff in a number of activities, including investigating possible insider trading violations. Provincial securities commissions are given the power to impose sanctions, such as cease trade orders, reprimands and fines (Anand et al. 1999: 63-66).

The securities commissions' efforts to enforce insider trading regulations have varied historically. By the mid-1960s Canada had earned an unfavourable international reputation for securities manipulation, since Canada had been much more concerned with stimulating than regulating capital investment. In Ontario, when angry complaints about insider trading in the Shell Oil takeover of Canadian Oil Companies were heard during the fall of 1962, OSC chair O. E. Lennox requested Attorney General Frederick Cass to order a formal investigation, although it was not clear that there had been any violations of securities legislation or of the *Criminal Code*. Considering the pressure from the news media, however, Cass agreed to issue an order. The OSC investigation did uncover some suspicious information. However, disseminating insider information was perfectly legal at the time, although it might have been contrary to accepted business ethics (Armstrong 2001: 224-225).

Jack Kimber, who chaired the OSC following Lennox's death, pointed out that it would be difficult to regulate takeovers without also considering the conduct of corporate insiders. In October 1963 Attorney General Frederick Cass appointed a committee headed by Jack Kimber, consisting of Deputy Attorney General W. B. Common and lawyer R. A. Davies, with its mandate to consider changes in the regulations concerning both takeovers and insider trading (Armstrong 2001: 226).

The Kimber committee heard testimony strongly critical of the status quo. David Grenier of the Toronto Telegram, for example, unequivocally argued for the need to control insider trading (as cited in Armstrong 2001: 226):

The Windfall affair<sup>39</sup> raised a good number of questions as to how far the [stock] exchange, in its role as a self-policing institution, was able to achieve a proper regulation, or whether there was a prima facie case ... that the [Ontario Securities] Commission should have exercised a more immediate disciplinary effect on the company concerned.

Liberal politician Elmer Sopha also called for governmental action against corporate violations (as cited in Armstrong 2001: 226):

I don't believe in self-regulation, and I don't believe in self-policing; I don't believe in setting up what are in effect clubs and saying to people, 'well, we entrust to you the responsibility for being good and obeying the law, and seeing that the investor gets a fair shake...' There is the test ... they don't work; the self-regulating body does not police itself and a good many innocent people get hurt and hurt in such a way that they can ill afford to sustain the losses. We have seen it time and time again.

Because of "the unfavourable international image of Canada gained through bad stock deals," re-establishing "investor confidence" and "the credibility of the marketplace" became prominent concerns to encourage investment for industrialization. This impetus led not only to the passage of securities legislations, such as the Ontario *Securities Act*, 1966, but also to increased policing and enforcement efforts (LaPrairie 1979: 275, 288; Hagan and Parker 1985: 303). The US SEC's prosecution of insider

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<sup>39</sup> The notorious Windfall scandal revolved around a mining swindle which caused the collapse of Windfall's shares on the Toronto Stock Exchange and large profits for the promoters of the company. In 1964, George and Viola MacMillan, a couple of well-known promoters in Toronto, brought a worthless mining claim next to a huge discovery of copper in northern Ontario. The couple let the rumours spread that their company, Windfall Oil and Mines Ltd., had found copper, which resulted in a market mania and a boost of Windfall share price. The Windfall collapsed on the following day, after the MacMillans were forced to divulge their assay results. The MacMillans earned \$2 million from the scam and were charged with manipulating the Windfall stock price. But they were never convicted for the Windfall affair, although Viola MacMillan was later convicted and sentenced to nine months in jail in connection with another company of theirs. The Windfall affair was a significant factor in the rewriting of the Ontario *Securities Act* and extensive expansion of the OSC's powers (Armstrong 2001: 155-198).

trading against Texas Gulf and thirteen of its employees and directors in the late 1960s inspired a much more stringent regulatory system against insider trading offences modelled upon the SEC in the United States.

Hagan and Parker (1985), using interviews with investigators involved in prosecuting securities violators from 1966 to 1983 in Ontario, found that prosecutions and convictions went up over the period studied. However, limited attempts had been made to deal with illegal insider trading by the OSC during the period, although there was a significant amount of empirical data to confirm that insider trading was common (Rosenbaum et. al. 1983-1984: 485). Canada's securities commissions had demonstrated little success in prosecuting cases of improper insider trading.

The number of insider trading enforcement actions brought by the securities commissions increased to some degree during the 1980s. The OSC chair asserted, in an interview in February 1985 with the *Globe and Mail*, that the Commission had opted for a hands-on approach (Howlett, 1999, October 20: B1). Several members from the Canadian business elite were under an enforcement probe by the OSC. In 1981, Royal Trustco Ltd. Chairman Kenneth White lost his trading privileges for 60 days for improperly giving inside information to the Toronto-Dominion Bank during an unsuccessful takeover bid for Royal [see *Re Royal Trustco* (1983)], then the country's biggest trust company. The penalty followed four days of testimony by Canada's business elite, including TD Bank chairman Richard Thomson, Canadian Imperial Bank of Commerce chairman Russell Harrison, real estate developer Paul Reichmann and Noranda Inc. chairman Alfred Powis.



## *The History of Chinese Insider Trading Laws*

### **Development of Chinese Securities Markets**

The history of securities markets in China can be traced back to its beginnings in the 19<sup>th</sup> century when major capitalist powers broke open the country's closed door with firearms (Gu 1994: 15). The first companies in China run in partnership or with bond sales were mostly the British ship companies, like Qi-Chang Ship Co. established in 1861, Sino-Japanese Ship Co. in 1862, Fair Ship Co. in 1867 and Tai-Gu Ship Co. in 1872. With limited capital brought in, they sold bonds to finance their businesses. Shortly after that, some major Chinese investors like compradors,<sup>40</sup> government bureaucrats, landowners and businessmen in these companies, with their knowledge and experience from investment operation, began the earliest Chinese experiments with securities. Following the example of foreign companies, the first Chinese modern company Ship Business Bureau was set up in 1872, by several big compradors and shareholders of foreign companies. From then on, several mining and textile companies were established by the joint efforts of the Qing dynasty's government and businesses, in order to raise funds for national industries, the military and other urgent purposes. In 1894 and 1898, the Qing government went further to issue government bonds to pay off war debts and improve naval equipments (Gu 1994: 15-16).

However, during the two decades thereafter, the securities trade was rather scattered without a tangible exchange. After the founding of the Republic of China in

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<sup>40</sup> A comprador, in the original sense of the word, was a native-born Chinese manager or senior employee in a foreign business. The compradors served foreign economic interests by acting as intermediaries in commercial transactions between Chinese and foreign companies. According to Mao Zedong, the comprador class had close connections with imperialism and profited from exploiting China's underclass and resources (Mao 1967: 13).

1912 by Dr. Sun Yat-Sen, the call for an exchange was becoming stronger from the business world. In 1914, the first Chinese securities legislation, the Securities Exchange Law, was issued by the northern government (Gu 1994: 16). Following the law, the earliest exchange location, the Stocks Trade Committee market, was set up in Wei-shui Court of Jiu-jiang Road of Shanghai in the same year, with the approval of the northern government. It followed the convention of a “tea party,” after which the Committee distributed quotation lists of the day to the members. From 1914 to 1917, the number of brokers increased from 13 to 60. They traded a great variety of bonds and stocks of private companies and of the government. In 1918, the first official stock exchange opened in Beijing, the capital of the northern government. In 1920, the official “Shanghai Chinese Business Stock Exchange” opened in Shanghai. By the end of summer in 1921, more than 140 stock exchanges had opened in the country, among which were many fraudulent ones (Gu 1994: 16-17).

After the founding of the Chiang Kai-shek Administration in Nanjing in 1927, the nationalist government strengthened the control over the securities markets, because of its greater reliance on them for raising government capital. According to its new law, there could only be one stock exchange in one city. Combining different exchanges into one brought several major exchanges into a period of great prosperity until the Japanese invasion in 1937, which caused the closure of most stock exchanges. In 1946, stock exchanges, which were even broader in scale, re-opened in Shanghai and other large cities. Before the Second World War, the Shanghai Stock Exchange was the largest stock market in Asia. However, they suffered from a number of problems, and were permeated

with speculation and other misconduct. The communist regime shut them down shortly after it won the war with the nationalists in 1949 (Gu 1999: 29).

Such a brief overview of the 19<sup>th</sup> and the early 20<sup>th</sup> centuries indicates that the development of securities markets during wartime was largely an annex to military politics. Securities regulation was merely an instrument for the government to control the state economy and raise government capital in a simple and direct way. The rights of public investors and confidence in the markets were largely neglected. The direct circulation of necessary funds by the government compressed the space for people-to-people trade. In spite of the enactment of securities laws, the government itself did not comply with them when it issued public funds to pay government debts (Zheng 2000: 120). This factor, together with uncontrolled speculation, caused very low confidence in and underdevelopment of the markets.

After 1949, although the government issued piecemeal national and local bonds several times, for ideological reasons it did not allow securities markets to re-emerge until the economic reform beginning in 1978. After the opening of China's economy in that year, a commodity economy allowing private ownership replaced the crumbling planned economy (Gu 1999: 29). Under the leadership of Deng Xiaoping, securities markets soon re-emerged to meet the needs of the dramatic economic growth, because the government and state-owned and private enterprises all needed cash infusions. To satisfy the urgent needs of many state-owned and private enterprises for equity capital, the public issue of enterprise stocks was initiated by Beijing Tian-qiao Department Store and Shanghai Feile Acoustics in 1984. In September 1986, Shanghai Trust and Investment opened up the first government-sanctioned securities broker, followed by a number of

local brokers (Gu 1999: 29). In 1990, approved by the State Council, Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were established as the only two exchanges for enterprise stocks and were developed into national stock exchanges in 1993. Since then a number of government sanctioned investment houses, which are obliged to report their transactions to SSE and SZSE, along with unsanctioned street markets, emerged to trade bonds and stocks. By the end of 1998, SSE and SZSE had 2,412 trading offices, a computerized system, 851 listed companies from 30 provinces all over the country, 97 securities companies, 100,000 trained industry professionals, 21 million shareholders and a total market capitalization of 1,950.5 billion RMB yuan equivalent to 24.46% of GDP (CSRC 1999).<sup>41</sup>

### **Structure of Shares and Shareholders and Its Effect on Insider Trading Laws**

Because China created its securities markets to extricate itself from the capital crises of both state-owned and private enterprises, and therefore to meet the needs of the “socialist market economy,” the structure of shares and shareholders is greatly different from, and more complicated than, that of major western countries. Listed stocks on the Toronto Stock Exchange (TSX) and TSX-Venture Exchange are usually common shares and preferred shares only, while stocks in Chinese companies go far beyond this system. There are four main categories of shares – A share, B share, H share and N share, which are categorized according to different eligible buyers, denominating currency and the listing location. A shares, both common and preferred, embody the most common characteristics of stock ownership. Listed on the national stock exchanges, the principal and dividends of A shares are denominated in the Chinese RMB yuan. A shares had not

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<sup>41</sup> The CSRC is somewhat slow to update this information.

been available to foreign investors until recently, because the government still worries about free, direct and large-scale foreign investment into Chinese markets, which may affect the RMB yuan as a semi-convertible currency and dilute the “Chinese characteristics” of the market economy. The Qualified Foreign Institutional Investor (QFII) program, promulgated in December 2002, aims to allow foreign institutional investors to participate in the A share markets. It allows fund management companies with at least US\$10 billion in assets to invest in China’s A-share markets after approval. By the end of 1998, China’s listed companies had issued a total of 74.61 billion shares in the markets and raised a total of 355.31 billion RMB yuan (CSRC 1999).

Since China urgently needs foreign investment for its economic development, the Chinese government reached a consensus in 1992 to “attract foreign investment by stages and with proper steps” (No Author 1996: 3), which resulted in the issue of B shares. B shares were initially available only to foreign investors and had to be purchased with foreign currency. From February 2001, domestic investors became eligible to trade this type of shares (CSRC, Policy Document, 2001). Because of the worry of losing the “Chinese characteristics” of the market economy, the government imposed several limits on the issuance and trade of B shares. For example, only state-owned companies and major joint ventures controlled by government funds were allowed to issue this type of shares. In order to issue B shares, a company must make twenty-five percent of its shares available to the public and maintain a foreign exchange account within China.<sup>42</sup> In

addition, B shares are not directly open to the public in foreign countries, but rather sold

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<sup>42</sup> According to the Chinese official Xinhua News Agency, a new government policy in China will remove some of the restrictions in order to allow more domestic companies to issue B shares. This means that some private and foreign-funded companies will be allowed to issue B shares in the near future (South China Morning Post, June 17, 1999). To date, however, the Chinese government has not made any changes to the original restrictions.

by underwriters to foreign or domestic professional securities dealers who then accept foreign public investors' consignment for trading. In spite of these limits, B shares trade has still grown dramatically. By the end of 1998, 186 companies had issued 9.598 billion B shares and sold a total of 4.745 billion US dollars worth of such shares (CSRC 1999).

H shares or "red chips" are Chinese company listings in the Hong Kong Stock Exchange (HKSE). N shares are Chinese company stocks listed on the New York Stock Exchange (NYSE), in the form of American Depository Receipts (ADR). Both H shares and N shares provide more confidence for foreign investors in Chinese securities because they are supposed to comply with the criteria of the US Securities Exchange Commission and the Hong Kong Securities & Futures Commission (Yang 2001: 25).

In addition to the above categories, stocks in Chinese companies are classified into four different groups, according to the strict categorization of potential purchasers. They are state shares, legal person shares, employee shares and individual shares (the latter being the only tradable shares). By the end of 1998, the total untradable equities of the listed companies was 166.48 billion shares, comprising 65.89% of the total equities of the listed companies. The government owned 86.55 billion, legal persons 71.62 billion, employees and others 8.32 billion. Tradable shares totalled 86.19 billion shares, which amounted to 34.11% of the total equities of the listed companies (CSRC 1999).

The different categories and classes of stocks led to different groups of stockholders in the markets, among whom A share domestic investors and B share foreign investors are of utmost importance for the Chinese government to attract major investment for economic development. These shareholders' demands for improvement of

the securities system have given impetus to the government efforts to make and enforce insider trading regulation.

With the largest population in the world, China has the greatest number of potential small investors (Williams 1996: 52).<sup>43</sup> By the end of 1995, Chinese citizens had invested 100 billion yuan in stocks (Xinhua News, Nov. 25, 1995). They constitute the majority of the total number of investors in the Chinese stock markets. By the end of 1998, investors had opened 39.1 million investment accounts, of which 38.95 million were in the name of individual investors (CSRC 1999). However, as new hands in securities markets, they are the most vulnerable to insider trading and other misbehaviours. Without a good knowledge of the market mechanisms, their enthusiasm has largely been aroused by the government policy and the official news media (Poole 1994: 21). They tend to trade stocks based on rumour, hearsay or patterns in recent price listings that they follow, without much understanding of the market and without enough guidance from investment advisors (Kahn 1994: A11).

While other jurisdictions like Canada and the US continue the academic debate over whether insider trading is harmful in efficient markets (Gillen 1992), there is a complete consensus on the harmfulness of insider trading among scholars and small investors in China. They argue that insider trading in the inefficient markets of China allows insiders to benefit from the informational inefficiencies and discourages them from disclosing material information. The possibility that they might be denied access to necessary information is the greatest danger for small investors in trading stocks, and can also become a major threat to political stability and economic development (Poole 1994:

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<sup>43</sup> Williams estimated that 80 percent of the Chinese stock market consists of small investors. In fact the percentage is even higher today.

22). The downturn in A share markets has always been attributed to small domestic investors' dissatisfaction with prevailing insider trading. Riots provoked by big insider trading scandals by high-level party cadres and other insiders are one of the potential consequences the government fears the most. Therefore the small investors exert a great deal of influence on the insider trading regulation policies and practices of the Chinese government.

Foreign investors who trade B, H, or N shares are the second major force to demand a strict insider trading law from the Chinese government. Through voices of their own and foreign leaders and lawyers, they call for the enforcement of securities regulation and the eradication of insider trading through sufficiently severe sanctions against fraudulent activities in the securities markets. According to this group, insider trading allows domestic insiders to profit at the expense of foreign investors. Their spontaneous response affects prices of B shares and threatens the B share market, and finally affects the A share market. When this situation happens, foreign and domestic investors will exert pressure on the government to take strong action against insider trading (Vancouver Sun, July 5, 1995: D4; Kahn 1994: A11).

Above all, as the greatest stockholder and the regulator, the government has a great self-interest in combating insider trading. Since China's state trading corporations are among the biggest players in the securities markets (Walker & Nickerson 1993: 28), a downturn in the stock markets has a direct effect on the nation's financial capacity. Fiscal stability is the most important priority for China's economic reformers (Tan 1993).<sup>44</sup>

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<sup>44</sup> It has been emphasized many times by former Chinese Premier Zhu Rongji.



As the regulator, the government faces the unique situation of market proletarianization, where the profiles of the average Chinese investor and the average Chinese citizen have been mixed together (Walker 1994: 10). Relying on the assumption of proper market operation, the average citizen invests a large part of his or her limited assets into the securities markets, hoping to gain from the investment. Market and social stability, which is the government's biggest concern, is closely linked to these small investors' confidence in the markets and government regulation. Insider trading is one of the most discouraging wrongdoings to small investors, which may lead to market and social instability and their distrust in the government. Moreover, the government needs foreign investment through the Chinese B share market to finance the domestic enterprises. The prevalence of insider trading will therefore have a negative impact on foreign investment and on economic reform as a whole.

### **Initial Legislative Efforts against Insider Trading**

Since in China the government, scholars, the investors and the news media all deem insider trading as harmful activity, Chinese legislation against insider trading has encountered little opposition. Interviews indicate that insiders themselves consider insider trading as contrary to the principles of equity, fairness and openness that govern the Chinese securities markets (Chan et al. 1994: 1). To attract investment for China's economic development, the government have increased its efforts to pass laws and regulations against insider trading since 1990.

In 1990, the *Provisional Measures Controlling Securities Firms (PMCSF)* was issued by China's central bank, the People's Bank of China. This regulation was the very first to prohibit securities firms from "price-fixing, insider trading, fraud, or other trading

or behaviour which influences the quoted market prices in order to reap undeserved profits” (*Temporary Measures Controlling Securities Firms*, Art. 17, October 1990). Those who commit insider trading are liable to receive a circular of notice of criticism,<sup>45</sup> confiscation of illegal earnings, a fine,<sup>46</sup> an order for auction of treasury stocks, a partial or total cease trade order, and/or dissolution of the company. This law did not prohibit government officials and party cadres in management positions from insider trading (Karmel 1994: 1117). However, there were no cases reported or disclosed by the news media under this statute.

The Shanghai and Shenzhen municipal governments issued the *Regulatory Measures of Shanghai Municipality Securities Trade (RMSMST)* and *Regulatory Measures of Shenzhen Municipality Securities Issuance and Trade (RMSMSIT)* respectively, in 1990 and 1991. Both local regulations prohibited insider trading, fraud and black market dealings in securities markets (*RMSMST*, Art. 39(2), November 1990; *RMSMSIT*, Art. 43(4), November 1990). Article 8 Section 75(6) of the *RMSMST* went further to stipulate a fine of between 50,000 and 100,000 RMB yuan for general cases and between 100,000 and 200,000 RMB yuan for severe cases.<sup>47</sup>

Before 1993, however, there had been no clear legislative definition of “insider trading,” “insider,” “inside information” and other related concepts. Many government officials and company insiders who colluded to make profits from trading on insider

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<sup>45</sup> A circular official document used in China, printed and disseminated by a relevant regulatory or disciplinary agency, for the purpose of drawing public criticism.

<sup>46</sup> However, this statute did not provide a maximum or minimum amount of fine.

<sup>47</sup> Unfortunately there was no further legislative, judicial and administrative interpretation of what constitutes “severe cases.” In fact this problem of uncertainty about the criteria for “severe cases” exists in many statutes in China. Because China is not a common law jurisdiction, this problem leaves too much room for judges’ discretion and often leads to judicial and administrative corruption.

information easily escaped punishment. The illusory expectation that trading securities was a sure way to get rich induced more than a million people to pour into Shenzhen to purchase “application forms for share lottery” on August 11, 1992 (Poole 1994: 22). It was discovered that corruption and fraud existed in this lottery. Government and bank officials had stolen over half of the application forms. The People’s Bank of China (PBOC), which had been in charge of running the markets, was widely blamed for this incident. Anger over the jobbery sparked riots by investors and posed a brief but serious threat to China's stock market experiment (Zheng 2000: 18).

Right after the Shenzhen Riot, Zhu Rongji, then the Deputy Prime Minister, took direct charge of the economy, headed the central bank and tightened regulatory controls over stock and other markets. The State Council issued the *Notice for Strengthening Macro-Supervision of the Securities Markets (NSMSM) (1992)*, which established the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC). Zhu himself chaired the SCSC and appointed Professor Liu Hongru, a financial reform expert and former Vice-Governor of the People’s Bank of China (PBOC), to be the first Chair of the CSRC. Liu thought that as the first Chair of the CSRC, he should lay a solid foundation for its future development of regulation. He regarded law-making as the first priority for the Commission (Securities Times 2000: 21).

According to the State Council’s Notice, besides the two newly established commissions, the State Commission of Planning, the PBOC, the Finance Ministry and the State Commission of Economic System Reform share the supervisory power of the securities markets with different emphases. In addition, the local governments of

Shanghai and Shenzhen established their own municipal securities commissions and other supervisory organs. Over the years, therefore, a variety of overlapping and sometimes confusing regulations were issued by these different regulatory organs, among which the Provisional Regulations for Oversight of Stock Issuance and Trade (PROSIT) and the Provisional Measures Forbidding Securities Fraudulent Behaviour (PMFSFB) are the two most important regulations that the CSRC proposed to the State Council (No Author 1997).

### **The *PROSIT* and the *PMFSFB***

On April 22, 1993, the *Provisional Regulations for Oversight of Stock Issuance and Trade (PROSIT)*, the first formal national securities legislation of China, was issued by the State Council. This statute provided a brief definition of insider trading and its liability. Section 72 of this statute prohibited insiders and other people who learn of undisclosed inside information by illegal means (tippees) from leaking, trading on, or tipping others to trade on such inside information. Five months later, the State Council issued another important statute, the *Provisional Measures Forbidding Securities Fraudulent Behaviour (PMFSFB)*. In this statute, insider trading was placed first on the list of fraudulent behaviours that the government aimed to deal with. The statute also defined in more detail the concepts of insider trading, insiders, and inside information.

According to Chinese scholars, “insider trading” usually includes two categories: the use of inside information by an insider for self profit-seeking, and the leaking of inside information by an insider to a third person, allowing the latter to engage in illegal trading activities (He 2000: 83; Gu 1999: 335). This dichotomy of insider trading activities has been adopted by several insider trading regulations and laws. It is similar to

the Canadian definition of direct trading on inside information and tipping (see Section 86 and Section 136, *BC Securities Act*, RSBC 1996, Chapter 418.). But according to the wording of the Chinese insider trading regulations and laws, the leaking of inside information may cover even broader situations depending on the regulatory body's discretion.

Article 4 of the *PMFSFB* defined insider trading to encompass the following practices:

1. an insider to trade on inside information or to suggest a third party to trade certain securities according to inside information;
2. an insider to leak inside information to a third party, enabling that person to explore the information to engage in insider trading;
3. a non-insider, through improper means or other channels, to obtain inside information and to trade on that information, or to encourage a third party to trade; or
4. other insider trading behaviours.

It is worth noting that the *PMFSFB* copied the "short swing profit" prohibition (Art. 38, *PMFSFB*) from the United States [Section 16(b), *The US Securities Exchange Act of 1934*], which considered short swing profit as insider trading. According to Article 38, "an incorporated company's directors, supervisors, officers, or shareholders with over five percent of the voting shares who sell shares bought within the last six months, or who buy shares sold within the last six months, must remit to the company the profit gained on the transaction." Trading within six months in this case is automatically deemed to be insider trading (He 2000: 233).

The CSRC first invoked this provision in the administrative acquisition case of *In re Baoan Group* [The CSRC (1993) 99 Issue 4].<sup>48</sup> By September 29, 1993, the Shenzhen-listed Baoan Group and its affiliated companies had secretly purchased 10.65 percent of the shares of the Shanghai-listed Yanzhong Group, the first company in China to issue stocks generally to the public. They purchased the stock on the open market, without reporting their trading to either the CSRC or the stock exchanges as required by the law.<sup>49</sup> On September 30, Baoan continued to purchase Yanzhong shares. On the same day, its affiliated companies sold 1,147,700 Yanzhong shares to the Baoan Group through the Shanghai Stock Exchange trading system, and 246,000 additional shares to the open market. Baoan announced the number of its purchased Yanzhong shares at the Shanghai Stock Exchange when it had already held 17.07 percent of Yanzhong shares. The CSRC held this acquisition valid, but found Baoan's affiliated companies liable for insider trading according to Article 38 of the *PMFSFB*. The Commission issued a reprimand to Baoan's affiliated companies and ordered that they remit to Yanzhong Group the profit gained on the 246,000 shares sold on the open market.<sup>50</sup>

The *PMFSFB* also provided a definition of "insider." Article 6 of the *PMFSFB* categorized insiders into five groups:

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<sup>48</sup> For a discussion of this case see Zheng (2000: 33-34).

<sup>49</sup> According to Article 47 of the *PROSIT*, an institutional shareholder who holds 5 percent of the shares issued by a company limited by shares shall, within three days from the date on which the number of shares held by him or her reaches this percentage, report the same to the company, which shall, within three days from the date on which it receives the report, inform the securities regulatory authority of the same under the State Council. If the company is a listed company, it shall notify the stock exchange of the matter at the same time.

<sup>50</sup> The Commission also held Baoan Group liable for a reprimand and fine of 1 million RMB yuan for non-disclosure.

1. directors, supervisors, officers, secretaries, typists, and other personnel of the issuer who come into contact with or obtain inside information through the performance of their duties;
2. lawyers, accountants, capital asset appraisers, investment consultants, regulators of securities institutions, market participants, and others who because of the performance of their duties encounter or obtain inside information;
3. an individual who, on the basis of laws or regulations, has control or supervisory rights over an issuer, including the employees of securities regulators and exchanges, employees of the issuer, and the employees of any examiners or auditors...;
4. an individual who, on the basis of his occupation, or who, by means of a contractual or employment relationship with the issuer, may encounter or obtain inside information, including news reporters, magazine editors, television directors and printers; and
5. other employees who may through lawful channels encounter inside information.

One important type of insider derives his or her insider status from his or her official position. This *de facto* insider is a government official who comes into contact with inside information through his or her official duties (No Author 1995).<sup>51</sup> Improper trading by these *de facto* insiders has been a recurrent problem in the Chinese markets, as well as in Hong Kong, where Chinese officials often trade shares listed on the Hong Kong Exchange (Sharma, April 5, 1993).<sup>52</sup> To combat *de facto* insider trading, the *PROSIT* provided that “securities industry regulators, administrators, and other actors are prohibited from trading by the government and cannot directly or indirectly hold or trade shares, excluding the buying or selling of securities in an approved investment fund”

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<sup>51</sup> This article noted the increase in insider trading by Chinese government officials since 1989.

<sup>52</sup> Sharma (1993: 1) discusses in this article the use by Chinese officials of “insider knowledge of Beijing’s tirades against former Hong Kong governor Chris Pattern.”

(Art. 39, *PROSIT*).<sup>53</sup> Article 7 of the *PMFSFB* also prohibited work units and individuals involved with the securities trade from interfering with the market.

The *PMFSFB* also defined the phrase “inside information.” According to the Chinese literature, inside information usually has four characteristics. First, it must be related to securities issuance, trading and other relevant securities activities. Second, it must be known or accessible only to insiders and not yet to the public. According to most scholars, whether or not the information has been publicized depends on whether or not the market has digested the information. Third, the inside information must have an important potential impact on the securities market, particularly the market price of the stock in question and the investors’ gain or loss (Gu 1999; He 2000). The *PMFSFB* defined inside information as information which is “not yet public and capable of influencing the listed price of a security”(Art. 5, *PMFSFB*). It listed twenty-six specific categories of inside information, which include, *inter alia*, the signing of an important contract by the issuer, the changing of the issuer’s management policies, large investments or expenditures by the issuer, the shouldering of large debts, non-public difficulties in the repayment of debts, and non-public knowledge of operating losses. This long list covers a broad definition of such information (Art.5, *PMFSFB*).

The implications of such a wide scope interpretation of insider trading are clear. The State Council intended that it would grant the regulators a considerable degree of discretion in prosecuting insider trading cases. The statute allowed the regulatory body to

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<sup>53</sup> In addition to the laws and regulations, the Central Commission For Inspecting Discipline of the Communist Party and the Supervisory Ministry issued disciplinary rules to prohibit party and government officials from engaging in stock transactions. Whether or not the party’s internal disciplinary rules will effectively control insider trading and other corruption is uncertain, but party edicts have not yet solved the de facto insider trading problem. (See *Notice of Prohibiting Party and Government Officials from Stock Trading*, the Commission for Inspecting Discipline of the Chinese Communist Party and the Supervisory Ministry, 1995).



actually decide what constitutes “other insider trading behaviours” and “other employees” on a case-by-case basis.

According to the *PROSIT* (Art. 72) and the *PMFSFB* (Art. 13), those who commit insider trading, tipping and the leaking of inside information are liable to confiscation of illegal income and/or a fine between 50,000 and 500,000 RMB yuan. Furthermore, an issuer might receive one or more of the following sanctions for engaging in insider trading during the issuance of securities: a reprimand, an order to return illegally obtained funds, confiscation of illegal income, paying a fine, and having its issuance or trading approval stopped or cancelled (Art.14, *PMFSFB*). The *PROSIT* provided that the supervisory officials of the securities markets and other persons who are prohibited from trading stocks might be ordered to sell the stocks which they held within a limited time, and receive one or more of such sanctions as a reprimand, confiscation of illegal income, and a 5,000 to 50,000 RMB yuan fine (Art.72(2), *PROSIT*). The *PROSIT* has also issued a general provision on civil liability for any violations that cause losses for a third party. Insider trading could be reasonably deemed as such violation where a third party “can institute a civil action for compensation” (Art. 77, *PROSIT*).

In addition, the *PMFSFB* (Art. 27) has created a reward system for reporting illegal securities trading. Article 27 stated that “when a report from the public concerning securities fraud and other illegal securities behaviour is submitted, if the report is verified, a reward may be given to the one making the report.” This statute gave the CSRC the power to reward informants with a certain percentage of the money disgorged through a successful insider trading action. This is arguably an important incentive for people to speak up against colleagues and senior officials. However, the continuing broad

discretion concerning what constitutes insider trading has functioned to suppress the number of successful prosecutions.

### **The 1997 Amendment of the Criminal Law**

In the years since the enactment of the *PROSIT* and *PMFSFB*, the CSRC seems to have progressed little in its control of insider trading. A number of rumours about insider trading spread, but surprisingly few cases were filed by the CSRC. The present remedies were also seen as inadequate deterrents. Before 1997, although several regulations including *PROSIT* and *PMFSFB* established that certain violations of insider trading provisions might be subject to criminal liability (Art.78, *PROSIT*, and Art.13(1), *PMFSFB*), China had no specific criminal offence for insider trading, let alone criminal sanctions against it.<sup>54</sup> However, there is a universal demand among small investors for imposition of criminal liability for insider trading. Public reaction was especially acrimonious following the Shenzhen Subscription Event in 1992 (Shenzhen Securities Supervision Office, 1992), when 4,000 insider trading offenders in the financial organizations escaped criminal conviction because the laws were inadequate. Many Chinese commentators noted that a high proportion of insider trading offences were committed by government officials or state-owned company officers who took advantage of their positions. Some legal scholars called for law reform and presented model criminal code language to address insider trading offences (No Author 1995: 31-46). Against this background, the 1997 *Amendment of the Criminal Law of the People's*

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<sup>54</sup> In Chinese law, conduct that is in breach of a statute provision is considered a crime only if it violates the Criminal Law (Lu 1994: 55).

*Republic of China (CLPRC)* finally added insider trading as a new type of crime. Article 180 stipulates:

People who have inside information on securities trading, illegally obtain inside information on securities trading, or buy or sell securities or leak relevant information prior to the release of information that could have a major effect on the issuance and trading of the securities concerned or on the price of other securities shall be sentenced to not more than five years in prison or criminal detention, provided the circumstances are serious. They shall be fined, additionally or exclusively, a sum not less than 100 percent and not more than 500 percent as high as their illegal proceeds. If the circumstances are especially serious, they shall be sentenced to not less than five years and not more than 10 years in prison. In addition, they shall be fined a sum not less than 100 percent and not more than 500 percent as high as their illegal proceeds.

If insider trading crimes are committed by a company or organization, the company or organization in question shall be fined, and the individual directly in charge of it or people who are directly responsible shall be sentenced to not more than five years in prison or criminal detention.

It can be argued that criminal sanctions for insider trading in the Chinese law are actually tougher than comparable penalties under Canadian law. However, it is open to doubt that the ten-year term of imprisonment as a maximum for the most severe cases in China is an effective deterrent to insider trading. There has been little evidence suggesting that substantial additional deterrence will be achieved by extended incarceration. It is probably the fear of being caught and punished, not the length of imprisonment that may primarily deter insiders from illegal trading.

The jurisprudence in China suggests that whether and what criminal sanctions should be imposed depend on the intentionality of the violation, the seriousness of the conduct, the effect on other participants in the stock market, especially the trading public,

and the need for investor confidence in the market (Ma 2000: 26-30). It should be noted that, however, the Chinese courts have been instructed by the government to impose quick and severe criminal sanctions in cases of economic crime in recent years,<sup>55</sup> because the Chinese government wants to appease public discontent and divert blame away from its own economic mismanagement by cracking down on corruption and abuse of power. However, there is no clear judicial guidance for how to determine the severity of cases and hence the severity of punishment. It is again doubtful that sanctions stipulated in such an uncertain way in the context of the notorious Chinese judicial system will effectively deter insider trading offenders.

### **The Securities Law of the People's Republic of China**

Deliberations over a more effective national securities law to regulate the securities markets had also been underway since 1992. However, this legislation experienced the most difficult and lengthy process in Chinese legal history. The drafters' group of the Congress, which was organized on July 11, 1992, had invited a number of government officials at both the central and local levels, along with judicial officials, officials of stock exchanges, securities companies and issuing companies, thousands of investors and legal experts and professionals from more than ten countries, to participate in related discussions. They basically agreed that the new legislation needed to address the problem of illegal insider trading. However, some called for stricter and more effective provisions against insider trading and other securities offences, while others advocated a more lenient approach. Professor Xiaorong Gu, a draftsman who was in

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<sup>55</sup> Some would doubt, however, whether such a quick decision on criminal liability is really based on sufficient evidence.

favour of a strict policy, stated in an interview with this author, “We had too few commonalities with them. The debates were held in an extremely tense atmosphere. Some of them even left the discussion midway in a great rage.” In 1996, the CSRC went its own way and proposed a new draft version to the Congress, but did not receive any favourable responses.

The financial crisis that erupted in Asia in mid-1997 led to sharp declines in the stock markets of a number of Asian countries including China, and put pressure on the Chinese government to improve the securities law. On November 7, 1997, the first National Financial Work Meeting was held by the Central Committee of the Chinese Communist Party, which decided to speed up the drafting and implementation of the *Securities Law* and authorized the CSRC to coordinate this process.

On December 29, 1998, the CRSC’s draft was finally passed by the Congress and became the new *Securities Law of the People’s Republic of China (SLPRC)*. The goal of this act was to better “accumulate investment capital, supervise the issuance and trading of stocks, protect the rights of investors, safeguard social and economic order and public interest, and promote the development of the socialist market economy while boosting the growth of new and high-tech enterprises” (CSRC 1998). This new legislation maintains the prohibition against insider trading in more detail and increases legal liability on insider trading.

The *SLPRC* sets forth a similar but more detailed definition as to the nature of inside information and under what conditions trading and informing on inside information are prohibited. Article 70 of the *SLPRC* states (Art.70, Section IV, Chapter III, *SLPRC*, 1998):

Insiders with inside information about a company's securities trading, or other persons having illegally obtained inside information, shall not buy or sell the securities in question, leak relevant information, or suggest that other people buy or sell the securities in question.

Article 183 goes further to make it clear that trading and informing others who might trade in securities on the basis of inside information are prohibited only where such information has not been made public (Art.183, Chapter. XI):

Those having access to or having illegally obtained inside information about securities transaction who, before information concerning securities issuance or transaction or other information that would have an important effect on the prices of securities is announced, buy or sell the securities in question, disclose relevant information, or suggest that other people buy or sell the securities in question, are [legally liable.]

In addition, the new Law confirms that short swing profit constitutes insider trading. Article 42 provides that (Art.42, Section I, Chapter III):

Where the stockholder [with five percent of a company's stocks] sells the stocks of the company in his possession within six months after he purchases them, or where he buys them back within six months after he sells them, profits from the transaction shall belong to the company and the company's board of directors shall take back the stockholder's profits. Where the securities company, as the sole underwriter, purchases all the unsold stocks and therefore exceeds the five-percent possession limit, it is exempt from the six-month restriction when it resells the stocks.

Article 39 states that (Art.39, Section I, Chapter III):

Any special organization or its personnel that have prepared an auditing report, assets appraisal report, or legal advice for the issuance of a stock are prohibited from buying or selling the stock in question while the stock is being underwritten and within six months after the period of underwriting. In addition to provisions of the preceding paragraph,<sup>56</sup> any special organization or its personnel that prepares an auditing report, assets appraisal report, or legal advice for a listed company is prohibited from buying or selling stocks of the company from the day it accepts the

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<sup>56</sup> The preceding paragraph provides that "stock exchanges, securities companies, and securities registration and settlement institutions shall keep their client accounts confidential in accordance with the law."

assignment until five days after the aforementioned document is published.

This provision applies regardless of whether the person or organization knew the inside information, whether the inside information was used and whether the act was well intended. The clause represents a vigorous effort to combat insider trading, although one can argue that under this legislation, inside trading may take place following the six-month restriction. As one Chinese article notes, the system may serve only to “postpone insider trading,” although it does present a barrier to some types of insider trading on the presumption that such information has a short useful life (Zhao 1995).

An insider can be an individual person, or an organization such as a securities exchange, a securities company, an issuer of securities, or a securities intermediary.

Article 68 provides a detailed list of insider categories (Art.68, Section IV, Chapter III):

1. Board directors, supervisors, managers, deputy managers, and other relevant senior administrators of companies that issue stocks or corporate bonds;
2. Stockholders holding five percent or more of a company’s stocks;
3. Senior administrators of a company that controls companies that issue stocks;
4. Persons who, because of their positions in the company they serve, can have access to information relevant to the company’s securities trading;
5. Persons working for securities regulatory agencies, and other persons who, because of their official duties, supervise securities exchanges;
6. Persons of intermediaries, securities registration and settlement, and securities exchange services, who are related to securities trading because of their official duties; and

7. Other people prescribed by the securities regulatory body under the State Council.

“Other people” include “a non-insider, who, through improper means or other channels, obtains inside information and trades on that information, or encourages a third party to trade” [Art.4(3), *PMFSFB*], and “other persons who may through lawful channels encounter inside information” [Art.6(5), *PMFSFB*]. Therefore, although the Chinese law does not specifically distinguish between an “insider” and “special relationship,” all persons who obtain inside information, legally or illegally, are prohibited from insider trading by the law, which on this point is theoretically similar to the Canadian law (Gillen 1998: 269-272). Even a tippee of another tippee will be prohibited from trading on the inside information. Furthermore, as discussed above, a stockholder holding five percent of a company’s stocks, a government official and any special organization or its personnel provided by Article 39 of the Law may face a much stricter liability system (270).<sup>57</sup>

As discussed above, party cadres and government officials constitute a large proportion of insiders. The number of cases of inside trading and other improper trading by Chinese officials has been increasing in the mainland securities markets and Hong Kong markets since 1989 (No Author 1995). This trend has greatly affected investors’ confidence in the Chinese markets. To redeem the confidence, the SLPRC has reiterated previous regulations that persons

working at securities supervision and administration organizations and other persons prohibited by laws and administrative rules and regulations from participating in stock trading shall not hold stocks, trade stocks and

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<sup>57</sup> In Canada, a stockholder holding ten percent of voting rights is regarded as an insider. See Gillen (1998: 270).



accept stocks given by other people, directly under their names or under false names or other people's names during the term of their positions or within the allotted time periods specified by the law (Art.36, Section I, Chapter III, *SLPRC*).

As to the meaning of "inside information," the new Law has adopted the spirit of *PROSIT* and *PMSFSB* and restated that "During securities trading, non-publicized information concerning a company's operations and financial situation, and information having an important impact on the market prices of the company's securities, is inside information" (Art.69, Section IV, *SLPRC*). However, the list of "inside information" has been reduced to eight categories (*Ibid*):

1. Important events listed under the second clause of Article 62 of the Law;
2. A company's plan for distributing dividends and increasing capital;
3. Important changes in the structure of a company's stock ownership;
4. Major changes in the company's security for debts;
5. The mortgaging, selling, scrapping of principal property that exceed one third of total property of a company at one time;
6. The conduct of a company's board directors, supervisors, managers, deputy managers, or other senior administrators that may undertake major compensatory responsibilities according to the law;
7. Plans relevant to the acquisition of listed companies; and
8. Other information that the securities regulatory body of the State Council identifies as having conspicuous effects on the prices of securities trading.

The first category under Article 62 of the Law refers to major changes that might have a considerable impact on the price of its listed stocks and of which the investors have no knowledge, including major changes of a company's operating policy and scope; a company's decision concerning its major investments and major property purchases; major contracts which might have an important impact on the company's assets, liabilities, rights, interests, and operating consequences; major changes in debts; major economic losses that exceed more than ten percent of net assets; major changes in the external conditions of the company's production and management; a change in the chairperson, or in more than one third of the directors or managers of a company; a major change in the holdings of the stockholders who possess more than five percent of the company's stocks; a company's decisions to reduce capital, merge with another company, establish a separate company, disband or apply for bankruptcy; major lawsuits or the court's cancelling of the decisions of the general meeting of stockholders or the board of directors; and other major changes stipulated by the law and regulations (Art.62, Section 4).

While the Chinese law covers all possible situations of the "material information" (Gillen 1998: 269) definition established by the Canadian insider trading legislation, it sets up a more certain and specific list, which has provided the regulatory body with better guidance for proving insider trading cases,<sup>58</sup> and at the same time has granted a considerable degree of discretion in prosecuting insider trading cases through the invoking of such broad categories.

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<sup>58</sup> Materiality is in many cases hard to prove. See Tomasic (1991: 5-16).

Administrative, civil and criminal sanctions against insider trading offences are all available under the new *Securities Law*. The new Chinese *Securities Law* provides a number of discretionary dispositions for persons or companies convicted of insider trading, including an order to dispose of the illegally obtained securities according to the law, the confiscation of illegal income, and a fine of one to five times the illegal income or an amount not more than the value of the illegally traded securities (Art. 183, Chapter XI, *SLPRC*). The change in the level of fines is probably a reflection of the increasing amount of funds involved in insider trading.<sup>59</sup> A fine between 50,000 and 500,000 RMB yuan under the *PROSIT* and *PMFSFB* has been perceived as inadequate in such cases. A draftsman of the *SLPRC* confirmed in the interview that this change is expected to exert a much stronger deterrent against insider trading offences (Interview with Professor Gu, December 2002). The new law also goes further to confirm that criminal liability might be imposed for the insider trading behaviour that has constituted a criminal offence according to the Criminal Law (Art. 183, Chapter XI, *SLPRC*).

Meanwhile, the *Securities Law* toughens the administrative sanctions on insider trading committed by party and government officials. Besides confiscation of their illegal income, these individuals might be fined an amount not more than the value of the illegally traded stocks, which is usually much higher than the 5,000 to 50,000 RMB yuan fine stipulated in the earlier legislation. They might also face other broad administrative penalties according to the law (Art. 180, Chapter XI, *SLPRC*). Furthermore, persons working in the securities regulatory body who engage in insider trading are to be given even heavier punishment (Art. 183, Chapter XI, *SLPRC*). Unfortunately, however, the

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<sup>59</sup> For example, in a case quoted by the securities regulatory body, the company committing insider trading obtained illegal income of more than 11.8 million RMB yuan (Shan 1997: 24).

*SLPRC* does not specify a set of other administrative penalties available to punish securities regulators and other party and government officials. It is also unclear who should be responsible for imposing such additional penalties. Some commentators criticized that such deliberate vagueness has expanded the Party's authority to deal with its members' insider trading offences through its own internal disciplinary processes, without referring the cases to regulatory or legal proceedings.

Unlike the Canadian legislation, the new Chinese *Securities Law* neither provides a general provision nor sets up a specific civil law sanction against insider trading, which requires compensation of profits, although theoretically civil liability exists wherever damage to a third party results (*The General Principles of Civil Law of the People's Republic of China*, 1986). Perhaps the legislators intend to rely on more of the administrative and criminal sanctions to effectively regulate insider trading, since it is difficult to institute civil actions in which damages are to be recovered in insider trading cases. Furthermore, the Chinese courts are relatively weak in deciding civil cases.<sup>60</sup> As the Chinese legal system develops, civil causes of action need to be paid much more attention in the interest of protecting individuals' rights.

## ***Conclusion***

Having examined the historical development of the laws creating white-collar crimes, James William Coleman (1994: 126-129) argued that in order to understand the

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<sup>60</sup> Civil law remains generally underdeveloped in China, partly because of the relatively short history of contemporary civil law in the country. Traditionally the state was primarily concerned with the protection of a hierarchical order, and showed little interest in developing civil law. Civil actions were usually heard at a criminal trial or resolved by community adjudicators. Civil cases had not been well distinguished from criminal cases until the 1930s, when the first civil code was enacted based on the Western legislation. Although the post-communist Chinese government has rapidly imported many civil and commercial laws since 1979, judges trained in the Chinese legal education system still lack sufficient knowledge and skills to deal with civil cases. See Meijer (1967: 43-53) and Chen (1999: 219-247).

origins of such laws, we must look beyond the dynamics of interest-group politics to the social and economic forces that lie at the heart of the system of industrial capitalism. Conflicts and contradictions in the political economy of industrial capitalism provided the original impetus for the social movements that agitated for new legislation. Lauren Snider (1993: 139-141) pointed out that the regulation of corporate crime by the polity or state is an ever-changing dialectical process. It is, in other words, a struggle between opposing forces at several different levels. However, the ultimate consideration for the government to deal with white-collar crime is to protect its domination. The histories of insider trading laws in Canada and China are both in accord with these observations.

Throughout history, Canada and China have been subject to external pressures and internal opportunism (Gu 1994: 15-20; Armstrong 1997: 9-20). Prior to World War I, the source of these demands was primarily British; after World War I, they were increasingly American. In both cases, Canada encouraged and facilitated resource extraction as a source of foreign capital and a base of industrialization. In China, as a result of economic reforms and the opening-up policy, securities markets emerged to satisfy the urgent needs of many state-owned and private enterprises for equity capital, in the course of building so-called “socialism with Chinese characteristics.”<sup>61</sup> In order to ensure investors’ confidence in their securities markets and to catch up with the pace of the world market economy, the regulators in both countries face the same challenges to regulate insider trading offences more effectively. These common motivations have characterized the regulation of insider trading in both Canada and China.

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<sup>61</sup> Some scholars would probably rather call it “capitalism with Chinese characteristics,” since securities markets are concerned more with private businesses than with state-owned enterprises. But I would argue that the term of “socialism with Chinese characteristics” probably better reflects the present situation in China, because state-owned enterprises still dominate Chinese securities markets and the Chinese economy today.

Insider trading laws, when efficiently enforced, protect the sanctity of the investment market, which is itself central to the ability of corporations to raise money through the issuing of shares. Investors must have some degree of confidence that stock markets are operated in an honest and efficient manner, or the supply of capital, the engine of prosperity and expansion, will dry up. States, for their part, view healthy stock markets as necessary to ensure high standards of living and overall prosperity. Moreover, as players in the market themselves (investing the pension funds of government employees, for example), state officials have a direct interest in clean dealing. They will also experience pressure from high-income people, and negative publicity if investors are cheated or banks fail. Under such circumstances it may even be necessary for governments to step in and rescue defrauded investors, a very expensive proposition indeed.

This does not mean that forces opposed to regulation are absent. Pressures against enforcement are omnipresent because of the potential for powerful corporate actors and stockbrokers to make incredibly large sums of money. Insider traders can realize huge profits from their knowledge of the “real” financial circumstances of a firm, or their access to sources who know about takeovers in the early stages of negotiation. Entrepreneurs will also insist that their ability to raise capital for speculative ventures is hampered by “excessive” regulation. However, such arguments are weakened by the fact that the primary benefits of lawbreaking in this sector accrue to individuals, while the costs are shared collectively by business as a whole and, to a smaller degree, government; that is, insider trading brings large gains to individual actors or companies, but their costs

and consequences are borne by capital (and capitalism) as a whole (through loss of investor confidence), and by provincial and federal bodies of the state.

In China, such conflicts and contradictions are compounded by the fact that the nation is moving towards industrial capitalism, while politically still calling itself a socialist country under the leadership of the Communist Party. Another particular challenge is that China, within a very brief time span, has to achieve regulatory standards of insider trading which the major capitalist jurisdictions have developed for many years. To maintain the political order, the Chinese government has enacted even stricter insider trading legislation, and criminalized illegal insider trading behaviours of the elite from the dominant class bloc<sup>62</sup> and the rich business class.<sup>63</sup> Chinese law against insider trading is still determined by the interests of the party government, which will balance economic development with the political order. In reality, however, few insider traders – namely, those who constitute a threat to the existing political order – will be criminalized and punished.

The party directly interferes with insider trading law-making and enforcement through its powerful organizational network all over the country. First, through its representatives, the party is able to exercise control over all the legislative bodies, judicial institutions and regulatory agencies at different levels. In fact, all important court and administrative decisions must be approved by the party branches. And almost all high-rank securities regulators and chief judges are also party branch leaders. Second, the rules and policies generated by the party's central authority will gain quick and easy access to

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<sup>62</sup> The Communist Party and its various apparatuses, including state-owned corporations.

<sup>63</sup> There is also an increasing number of jointly funded project-companies that merge public and private ownership. Adopting a hybrid system of both market-orientation and state control, some would argue, results in a slow, government-led move toward “state-managed capitalism.”

every level through those organized channels of interaction and communication, with the consequences that these policies become legal guidelines for legislators, regulators and judges to follow. I would argue that the party's policies are in fact a specific form of law. Therefore, the party branch network has laid a foundation for the infrastructure of insider trading law in China.

In general, the party will be more lenient to insider trading behaviours, since the political regime needs the support of business leaders and corporations. However, faced with public anger and scared of social upheavals, the party will opt to punish a selected number of white-collar criminals in order to assuage popular indignation. In the dialectical view, conflicts between a public increasingly angry about insider trading, and the short-term economic incentives of individual officials, companies or localities can be resolved by laws that appease public investors while protecting the long-term interests of the party government's domination.

Corporations and individual members of the dominant class bloc would share common interests with the political regime in lawmaking in many cases. For example, the securities industry in China has generally been very supportive of laws directed at improper insider trading that promote a loss of trust among investors and potential investors, because these laws are regarded as facilitating a more stable and predictable business environment. However, it is important to emphasize that interests of the political regime, corporations and individual officials are hardly monolithic. Indeed, when regulatory laws' negative effects on profits outweigh benefits, corporations tend to oppose these laws and/or their enforcement. That is part of the reason why so few cases



of insider trading have been dealt with by the regulatory agencies of both countries in recent years.

Thus, we can expect enforcement of insider trading laws to be relatively efficient during some periods and inefficient during other periods. The governance of insider trading is caught up in dilemmas rooted in the power of the sector it regulates, and the primary role capital plays in the functioning of the modern state. Indeed, the need to safeguard the legitimacy of stock markets has forced both Canada and China to take strong action against insider trading from time to time. The next two chapters examine the role that the enforcement process plays in dealing with insider trading, by analysing major administrative and judicial cases of insider trading in the two countries.

## CHAPTER FIVE: INSIDER TRADING CASES IN CANADA

A central issue of the insider trading debate in Canada is the paucity of insider trading cases and the lack of convictions for this offence. From 1985 to 2003, the Ontario Securities Commission (OSC) undertook 23 inquiries into alleged insider trading activity. During the same period the British Columbia Securities Commission (BCSC) conducted a total of 17 insider trading inquiries. The Alberta Securities Commission (ASC) undertook only four inquiries into this offence during the same period. The *Bennett-Doman* case (1991) was actually investigated by both the OSC and the BCSC at the beginning, but the OSC discontinued its proceedings on the case after the court held that the OSC had no powers outside Ontario. The *Canadian 88 Energy Corp.* case (1997) was pursued by the joint efforts of the OSC and the ASC. Among these 43 cases, there were 16 convictions for insider trading with penalties ranging from \$1,200 to \$23 million, but only two jail terms imposed.<sup>64</sup> There were three cases where the penalties handed down for illegal insider trading were less than the profit generated from the crime – *In The Matter Of Bennett et al.* (1999), *In the Matter of M.C.J.C Holding Inc. and Cowpland* (2003) and *Cartaway Resources Corp. (Re)* (1999). There were four guilty pleas and a handful of negotiated settlements (such settlements, involving administrative remedies, are the most common response to insider trading offences). Four cases were dismissed and five decisions are pending.

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<sup>64</sup> Some of these cases were completed through administrative hearings and therefore imprisonment was not an option.

The overwhelming attitude, particularly among the news media, has been that insider trading laws are not adequately enforced. The insufficiency of enforcement is explained by several factors. The major hurdles facing enforcement staff in prosecuting insider trading have been attributable to the evidentiary problems. Staff and criminal prosecutors are strongly discouraged by judicial impassivity towards insider trading cases. With little available precedent, the courts seem to adopt a conservative approach. Insufficient resources and inadequate laws are also considered to be obstacles to full enforcement. Furthermore, as with other white-collar offences, the majority of insider trading cases in Canada probably do not even come to the attention of enforcers.

The experience of Canadian provincial regulators reveals very similar problems. According to the Executive Director of the British Columbia Securities Commission, “without the cooperation with industry, you’d never deal with something like insider trading” (Interview, July 2002).

This chapter examines the problem of insider trading in Canada, illuminates the difficulties the provincial securities commissions and Crown prosecutors face in obtaining administrative and criminal actions, and discusses judicial attitudes towards this type of offence, through a comprehensive analysis of administrative and judicial insider trading cases.

### ***The Extent and Effect of Insider Trading***

Insider trading is a type of white-collar crime regulated by provincial securities commissions in Canada. To evaluate the enforcement of insider trading offences, it is necessary to examine the extent to which insider trading occurs and its effect on markets. Canadian securities regulators generally agree that insider trading is a problem facing

them, but are divided on how prevalent it is. Some argue that insider trading is significant, while others state that they have not been convinced of the extent. Tom Atkinson, President & CEO of Market Regulation Services Inc,<sup>65</sup> for example, described insider trading as arguably the “toughest” issue facing Canadian market watchdogs today and intensely lobbied for a special task force to examine the problem (Stewart and Tedesco 2002: 1). When asked “Do you see it as a major problem in BC and in all of Canada?” a BCSC Vice-Chair observed that “substantively, the market misconduct called ‘insider trading’ ... yes, in my view, and I think, other members of the Commission” (Interview with a BCSC Vice-Chair, July 2002).

Most securities officials in Canada, however, assert that insider trading is not the most serious problem with which securities regulators have to deal. For example, in an interview with the *Globe and Mail* on October 22, 1999, the OSC chairman David Brown explained the lack of prosecutions: “we do not think that there is a widespread insider trading problem in this country” (No Author 1999: B1). This position is held by the BCSC Executive Director: “In British Columbia, I think that is true as well - market manipulation is a more serious, common occurrence than significant breaches of our insider trading laws. And the reason for that is that we have a relatively large junior market and it’s quite common for the insiders to not only trade, but trade with the intent of artificially inflating the stock price” (Interview with the BCSC Executive Director,

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<sup>65</sup> Market Regulation Services Inc. (RS) is the independent regulation services provider for Canadian equity markets, including the Toronto Stock Exchange (TSX), TSX Venture Exchange (TSX VN), Bloomberg Tradebook Canada Company (Bloomberg) and Canadian Trading and Quotation System (CNQ). They help protect investors and ensure market integrity by regulating trading on these marketplaces to ensure transactions are executed properly, fairly and in compliance with trading rules. RS is recognized as a self-regulatory organization (SRO) by the provincial Securities Commissions in Alberta, British Columbia, Manitoba, Ontario and Quebec, which co-operate in and co-ordinate oversight of their regulatory activities (See RS website [www.rs.ca/en/home](http://www.rs.ca/en/home)).

July 2002). Commenting on the creation of the Insider Trading Task Force, one senior official asserted, "I'm curious to know what the motivation is because it is not clear. We don't feel the crisis is founded" (Stewart and Tedesco 2002: 1). Another official even described the task force as "a power play [by the Market Regulation Services Inc]" (2002: 1).

Researchers, on the other hand, have been presenting consistent empirical evidence of widespread insider trading occurring in various markets around the world for over a decade, although no evidence of illegal insider trading was found particularly related to the Canadian markets. A *Globe and Mail* investigation also shows that in an alarming percentage of the large takeovers announced between July 1998 and July 1999, the share prices of the target companies rose in advance of a public announcement, suggesting that a tight circle of insiders was illegally profiting from that information. The investigation report stated that "of 28 friendly mergers or acquisitions, valued at more than \$150 million, that were announced during that one-year interval, the share price of almost half of the target companies rose by more than 25 percent between the times the companies began talking and the night before the deal was announced. In almost 20 percent of the deals, shares of the target company soared more than 50 percent." However, none of the individuals involved with the deals appeared before the commissions on illegal insider trading charges (Blackwell, 1999, October 23: B1).

In September 2002, Canadian securities regulators hired fraud expert Malcolm Sparrow from Harvard to help them create the Insider Trading Task Force to look at the extent of the insider trading problem in Canadian capital markets. The task force recently reported:

Due to data limitations, it is currently very difficult to establish accurately the extent of insider trading, much less illegal insider trading, that occurs on Canadian markets. Nevertheless, academic research consistently evidences trading on inside information on markets around the world. There is no reason to believe that Canadian markets would not also be victimized by these activities. With increased ease of access to offshore trading and the continued development of the options and single stock futures markets, illegal insider trading threatens to become more prevalent and profitable over time without strategies to mitigate the risk (Illegal Insider Trading Task Force 2003: 7-8).

Although it is difficult to quantify the precise extent of illegal insider trading, nobody would deny the occurrence of insider trading in Canada and its negative effect on the markets. As the BCSC Vice-Chair put it,

[Insider Trading is an] improper conduct, and it undermines the fairness of the markets, and therefore it undermines public confidence when it happens, and so, on that basis, fundamentally, I see it as a bad thing. That is not good for developing fair and efficient markets and for ensuring public confidence in those markets. Regulators need to deal with such offensive misconducts (Interview with a BCSC Vice-Chair, July 2002).

Some regulators agree that there is harm caused by insider trading, but they also tend to compare the seriousness of insider trading offences to that of street crimes or other more visible crimes, in order to moderate the harm caused by the former. For example, the BCSC Executive Director stated:

[I]nsider trading is an offence, and it's a serious case of a lack, of a decline of market integrity. But is it as bad as somebody going out and fleecing poor old ladies and elderly people, knowingly - deliberately defrauding them and taking their money? I don't know - the public interest harm is much easier to see in cases of pure fraud than it is in the case of insider trading. It's more of an indirect social consequence in the case of insider trading, whereas in the case of fraud, it's like shooting somebody in the foot, right? You're not going to kill him, but you can certainly slow them down a lot and you can take all their money, right?

While we cannot jump to a conclusion about regulators' ideological judgement on insider trading from these statements, it is reasonable to argue that their perceptions of the extent and effect of insider trading may affect the way they respond to the problem.

### ***The Detection of Insider Trading***

In obtaining information about insider trading activity, the securities commissions in Canada have seemed to follow a reactive approach, although they recently adopted a more proactive method to detect insider trading through the Market Regulation Services Inc. The sources of insider trading cases were summarized by the Executive Director of the British Columbia Securities Commission, in the interview:

**Cheng:** ... what are the sources of your insider trading cases? Mainly through the complaints, or mainly through your proactive measures?

**Executive Director:** They come mainly from two areas: one is from our normal complaint process. I would say we probably get over half of our insider trading referrals - cases referred to us - through the complaint process. And most of the rest would come from the exchange regulator, which we now call Market Regulation Services, the new regulator that oversees the markets, the market trading activity. They will catch insider trading - apparent insider trading - and then they refer it to us if it involves somebody that is within our jurisdiction rather than theirs.

**Cheng:** Do your staff do some inspection work in detecting insider trading or other illegal activities?

**Executive Director:** No. We regulate the market participants, which means we regulate the brokers, the mutual fund companies, the portfolio editors. They generally ... some of them sometimes get caught in insider trading, but generally they're not the main culprits. We don't regulate directly issuers - issuing companies for whom the insiders usually work. They are subject to our regulation, insofar as they publish financial results, financial information to support their fundraising activity. So, we don't examine them. We couldn't hope to examine them, anyway. It would be hopeless.

**Cheng:** And, you just mentioned the complaints. What are these kind of complaints - are they issuers, or are they...

**Executive Director:** No, they'd be mostly shareholders who complain. They would see something funny going on.

**Cheng:** But they don't have evidence - they just doubt.

**Executive Director:** Sometimes they do - sometimes they will have either anecdotal or actually, in some cases, hard evidence that somebody else in the company traded the stock when they shouldn't have. Or that they were using it to manipulate the market to the sharers and it's always in cases where they - the complainant - has been harmed in some way. You know, they see the stock price falling off dramatically, then they go back and they notice that the President of the company was dumping his stock before all this happened, and they get very suspicious. So they refer it to us. (Interview with the BCSC Executive Director, July 2002)

Complaints give life to the enforcement process, because insider trading offences are revealed by them. These offences would otherwise be difficult or even impossible for securities regulators to discover. Without complaints, certain insider trading activities would continue undetected because regulators are unable to watch all pertinent areas of trading activity. However, too great reliance on complaints can distort priorities by diverting resources from enforcement. A securities commission may be so overwhelmed with a number of time-consuming, trivial complaints that staff have to be transferred from other more proactive enforcement work to assist in their resolution. Furthermore, through complaints, we would likely uncover only certain offences and certain offenders, and would not be very capable of uncovering other major violations at an early stage of commission (Shapiro 1984: 98-99).

The Market Regulation Services (RS) initiative may, therefore, be an important contribution to securities commissions' intelligence. The detection of potential insider trading illegalities at RS is through a real-time computerized market surveillance system



and software that comprise various mathematical algorithms. During trading hours, RS surveillance officers continuously monitor company news, stock charts, chat room activity and other sources to identify unusual price or volume movements. When RS officers see unusual activity, they will often look at what is happening around a particular transaction, and then refer those matters to the securities commissions (Illegal Insider Trading Task Force 2003: 23-24).

However, current RS surveillance for illegal insider trading is still too young and inexperienced to discover every insider trading behaviour. One problem is that it lacks the full use of electronic insider trading alerts, including across-market insider trading alerts, which could be used to specifically identify illegal insider trading by determining whether the price or volume anomalies derive from undisclosed material information that has leaked into the marketplace. Therefore, it is sometimes difficult to determine whether an insider traded on the basis of inside information or merely speculated in advance of a significant event, and whether it was insiders or the outside world that had caused substantial changes in trading volumes or prices. As the Executive Director of the BCSC stated,

Well, ... it's very common when significant events happen to a company that its stock will begin trading in advance of that event. And it may or may not be anything illegal - it may be people just speculating that Company A is going to buy out Company B, so Company B's stock starts churning around. Brokers get wind of it and they start whispering to their clients, and their clients start buying it, and brokers start building up positions in it ... Anyway, you know, they just take a risk. There's lots of stuff on the Internet now - all kinds of stuff, all different companies. Most of it's completely bogus, right? But it causes ripples in companies' stock. And so when you go back and look at the trading in a company's stock to determine whether there's evidence that the insiders were active, you can't always tell that it's the insiders that were doing it, or whether it was the outside world that was doing it in speculation. So that's one challenge. (Interview with the BCSC Executive Director, July 2002)

Once suspicious trading is detected, one must identify the persons who did the trading. This will often require tracing back orders through the records of brokers to the persons who traded. This trace may simply reveal trading done through nominee accounts. Further tracing may be required to identify the true beneficiary of the trading. This can be especially problematic where the nominee account turns out to be a numbered account of an offshore bank having a policy of non-disclosure of client affairs. The Insider Trading Task Force found that current detection methods were not sufficiently effective in this regard. It reported:

Current surveillance practices are hampered by the lack of data-mining capability. Data-mining entails reviewing trading for evidence of patterns that indicate an organized effort to avoid detection. These tools work best where client data (for example, names, addresses, affiliates, subsidiaries) can be quickly and easily integrated with trade data to enable programs to be run electronically to identify these patterns. For example, programs run on integrated data are the only consistently effective way to identify the involvement of nominee and offshore accounts in illegal insider trading. Currently, it is not feasible for data to be integrated market-wide without significant technological improvements to data collection and retrieval software currently in use (Illegal Insider Trading Task Force 2003: 25).

The growing internationalization of securities markets is also making it possible to engage in transnational insider trading, which makes it even more difficult to identify insider traders. Since every country has its own national rules, insider traders may choose to perpetrate illegal trading with the same stocks in jurisdictions with weaker regulation to avoid any unfavourable laws. It has been suggested that every country should regulate “all transactions in shares of issuers of its nationality, wherever the transactions are effected and whatever is residence of the parties,” and that no nation should regulate “transactions in shares of issuers of any other country, even if the transactions are effected in the regulating country and between its own residences” (Fox 1992: 294). This

suggestion, however, can hardly solve the problem, and may in fact cause complicated international jurisdictional problems.

### ***Commission Investigations and Prosecutorial Discretion***

Whatever the source that reveals the potential insider trading, the Commission staff (the Executive Director) must make the decision whether or not to investigate. An informal preliminary investigation is normally conducted by a team of investigators before a more formal investigation can be justified. If an adequate reason is produced by the preliminary investigation, the Executive Director and staff can get an investigation order from a Commissioner who will not be involved in the hearing. The Commissioner may order a formal investigation pursuant to due administration of the Provincial *Securities Act* [A.S.A. ss. 28, 30-33; B.C.S.A. ss. 126, 129, 130, 131, 133 (the order can be made by the commission or the Minister); O.S.A. ss. 11-13]. The staff is responsible for investigating these alleged offences and preparing investigation briefs, which are either used for possible prosecution in the Provincial Court or referred to the Executive Director with recommendations for administrative proceedings before the Commission.

The investigators are given broad powers to conduct administrative investigations, including summoning and enforcing the attendance of witnesses, and compelling witnesses to give evidence under oath and produce records [A.S.A. s. 29; B.C.S.A. ss. 127 and 128; O.S.A. s. 11(3) and (4)]. Powers are also provided for the appointment of a person to conduct an audit of the financial affairs of a reporting issuer, a registrant, mutual fund custodian or self-regulatory organization (A.S.A. s. 48; B.C.S.A. s. 137; O.S.A. s. 18). The person appointed is given the power to examine books of accounts, securities, cash, documents, bank accounts, and records of every description for the

purposes of conducting the investigation (A.S.A. s. 48; B.C.S.A. s. 137; O.S.A. s. 18). In certain circumstances, orders can be made to freeze a person's property in the jurisdiction. The securities commission can also order that the person subject to the investigation refrain from withdrawing any funds, securities, or other property (A.S.A. s. 37; B.C.S.A. s. 135; O.S.A. s. 16).

The deliberative conduct of the commission, particularly surrounding enforcement matters, is shrouded in secrecy. It is therefore difficult to characterize this critical juncture in the disposition of cases. In a letter to Minister Robert G. Elgie of the Ontario Ministry of Consumer and Commercial Relations on April 26, 1983 (6 OSCB 759 #8/83), concerning the OSC's investigation into alleged insider trading by Norcen Energy Resources Limited, the then OSC Chairman Peter J. Dey described this internal operating procedure in the Commission in full detail. He emphasized that Commission investigations are performed by Commission staff on a confidential basis. Normally a decision by the Commission not to initiate proceedings under the Act following an investigation will not be publicized. In addition, the Commission does not give reasons for its administrative conclusions based on staff recommendations. The Commission's review of the report of its investigators is not a public judicial proceeding, where all interested parties have an opportunity to present their case, but rather an internal administrative proceeding involving only staff and the Commission.

The Commission's practice, when the same matter is the subject of a parallel investigation by the police, has been to subordinate its investigation under the *Securities Act* to the investigation into more serious offences, namely the possible violation of the *Criminal Code* or quasi-criminal offences under the *Securities Act*. Normally, the

Commission staff defer their investigation while the police investigation continues, although the staff will maintain liaison with the police.

The securities laws vest the Commission with discretion in the decision to proceed formally against accused insider trading offenders. If the Commission is not satisfied with the evidence set out in the staff report, it will decide not to initiate proceedings under the *Securities Act*. In *Kaiser Resources Ltd. (Re)* (1981), where prominent Vancouver businessman Edgar Kaiser and other company insiders exercised stock options before the B. C. Resources Investment Corp announced a takeover, the OSC commissioners did not take action because they held that the trades had been induced by tax considerations and that no other shareholders were victimized (No Author 1999: B5). In *Noranda Mines Ltd. (Re)*, where Noranda executives Alfred Powis, William James and Kendall Cork were charged with illegal insider trading during the 1981 takeover of Noranda by Brascade Resources Inc., the OSC accepted the defence that the executives had made the sales to reduce large bank loans, and decided against holding a hearing (1999: B5).

In some cases, the enforcement staff themselves may determine whether or not there have been any violations of the insider trading prohibitions which deserve a formal investigation, after undertaking a joint review of the trading in question by the staff and outside legal counsel. In *BCSC v. B.C. Endowment Fund* (1993), the BCSC suspected that the B.C. Endowment Fund's purchase of MacMillan Bloedel shares was made with knowledge of undisclosed material information concerning MacMillan Bloedel and the Clayoquot Sound land use decision. After reviewing all of the available evidence,

however, the BCSC staff determined that there was no basis on which to allege that the B.C. Endowment Fund had committed illegal insider trading.

If the Commission is satisfied with the Enforcement staff's facts of the case and their justification for enforcement action, it may proceed with the case administratively or civilly or refer the case to the Crown prosecutor for criminal prosecution.<sup>66</sup> If the Commission approves of enforcement action, the person charged may still settle prior to the charges being filed before the Commission or the court. If no settlement is reached, an action is filed and an administrative hearing or prosecution ensues.

There is a significant "funnel" operating within insider trading enforcement, with a much lower number of insider trading crimes being detected and punished than the number actually committed. The Executive Director of the BCSC underscored this point in the interview:

**Cheng:** So, about how many cases, or do you have the percentage of how many cases you detect will be investigated?

**Executive Director:** Yes, I do. I can give you some general numbers, I can't give you the specifics ... between February of '98 and May of this year ... we investigated 43 cases... let me give you some percentages here ... about 40% of them were closed because there just wasn't enough evidence to tackle them ... (which means) 40% were closed without a formal investigation, because based on what we had, there wasn't enough to ...

**Cheng:** So maybe some cases are just very small, right?

**Executive Director:** That's correct. 15% of them were referred to other agencies, which means that while the issuing company might have been there, the actual insider was somewhere else. Or, while the stock traded on an exchange that we've regulated, the actual issuing company was located

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<sup>66</sup> British Columbia requires prosecution decisions to be made by prosecutors whereas Ontario staff may lay charges and prosecute quasi-criminal offences.

somewhere else. In other words, they had been referred to us ... there was no reason to refer them back. And so we refer them ... away ... Another 15%, we thought that they were ... there was evidence to proceed, but the amounts involved were so small that we ... it wasn't worth the cost of a big investigation. So we simply sent them a letter saying "we think you've been trading illegally - don't do it anymore."

**Cheng:** How about the other 30%?

**Executive Director:** That's right. Let's see ... Another 10% were ... we did conduct investigations, but there wasn't enough evidence to take them to a hearing. And the rest ... the rest we either settled with the individual - that usually means that he admits that he did it, and we arrive at an agreement for a fine or penalty, or they're still under investigation. (Interview with the BCSC Executive Director, July 2002)

Members of the Canadian business elite, including prominent Vancouver businessman Edgar Kaiser and mining executive William James, were among those who had been investigated by the OSC's enforcement arm on allegations of illegal insider trading, but the allegations were subsequently dropped (No Author 1999: B5).

The basis upon which the Commission staff make the decision whether to proceed with any investigation of the alleged insider trading cases was explained by the Executive Director of BCSC:

**Cheng:** ... on what basis do you make the decision whether to proceed with any investigation of the alleged insider trading offences?

**Executive Director:** Well, we have an analytical score card that we use to grade cases, and an insider trading case would have to stack up in terms of our score card. We assign points to various aspects of each case and then we add up the points. And if Case A has 30 points and Case B has 45 points, then if we can take any cases, it would be Case B. We would take Case B before Case A.

**Cheng:** Is that standardized?

**Executive Director:** Yes. We apply that to all the cases, the complaints that we get where we develop them into enough to be able to identify a

case. We have to grade it - it's just a screening system that helps us to make more efficient use of our resources.

**Cheng:** Is it open or is it confidential to the public?

**Executive Director:** Oh, no - it's confidential. We could never leak that one. That would be very useful information to many people out there. (Laughs.)

**Cheng:** Yeah.

**Executive Director:** But I can tell you what some of the criteria are. The criteria are things like: harm to the market, how many investors were involved, how much money was involved in the illegal trading, and whether or not there's a significant public interest issue - whether it's something we should take up (Interview with the BCSC Executive Director, July 2002).

The OSC have also developed a standardized set of case selection criteria, in order to select cases in a more objective manner. The selection criteria are similar to those described by the BCSC Executive Director, and have been made a formal rule. They include:

1. The number of investors affected and the value of their losses is significant.
2. The alleged improper activity is ongoing or investors' assets are at risk.
3. The activity appears to be pervasive.
4. Resolution of the case would likely have precedent value for future cases.
5. Resources required to pursue the case are proportionate to the conduct in question.
6. The activity has received sufficient public profile or media attention to affect public confidence in the integrity of our capital markets. (OSC Staff Notice 11-719)



No matter what techniques they have adopted, however, some regulators have basically demonstrated a great reluctance to come down hard on illegal insider trading. Because insider trading is a low priority for the provincial governments, the securities commissions do not enjoy much political support for investigating such offences. They normally lack sufficient labourpower and resources as well as adequate laws to deal with insider trading problems. In addition, the consequences of all the industry pressure are apparent on the enforcement fronts. Therefore, there was a glaring lack of action on high-profile insider traders by the commissions during the 1990s.

The OSC officials have admitted that they could be doing better on the enforcement front if they had sufficient personnel to achieve their efforts. Ermanno Pascutto, the former OSC executive director, stated that his staff had to concentrate on the few most important cases during the late 1980s, because the commission was especially short-staffed during that period. Brenda Eprile, the OSC executive director from 1993 to 1997, expressed similar opinions in the commission's 1994 annual report, that public expectations of securities regulators were "either unrealistic or misplaced," as long as the shortage of resources remained a problem. She stated that "Something needs to be done to educate investors about the very real limitations on the Commission's role and resources. Increased efforts will be made to communicate this more broadly" (Howlett, 1999, October 22: B1). The OSC became a self-funding agency in November 1998, and began to collect fees from industry for its operation. Although the Commission has much more funding now to add personnel and improve detection technologies, it is too early to predict the impact of self-funding on the effectiveness of its enforcement.

The reluctance and difficulties relating to insider trading enforcement also exist in the BCSC. Since insider trading investigation particularly involves a lot of personnel and resources, the BCSC Executive Director admitted that insider trading was currently not the commission's priority. He outlined the commission's practice as below:

**Cheng:** Could you estimate the percentage of time your investigators and enforcement staff spent on illegal insider trading over the past 1 or 2 years? Not a very specific percentage, just, you know, for example.

**Executive Director:** It would be between 10 and 15 percent. The majority of our time is spent with salespeople - people who sell stocks. We spend the majority of our time on them (who we call) registrants. These are people who are registered with us to sell securities. That's a big time-consumer. The next biggest, I would say, would be on what we call illegal distributions. These are the sale of securities illegally. These are people who want to raise money for their companies, so they just go out and start raising money from the public, and in some cases it's fairly fraudulent, so we had to stop it. And, let's see... what would be after those two? Those two would be probably the biggest. Another big area for us now is Internet fraud (Interview with the BCSC Executive Director, July 2002).

Fortunately, regulators have increasingly recognized the importance of dealing with insider trading for improving the reputation of the markets. For example, since David Brown became the OSC's chairman in April 1998, the OSC has launched a few high-profile insider trading cases. John Felderhof, former chief geologist of Bre-X Minerals Ltd., was charged with illegally selling \$83.9 million worth of shares well before the world found out that the company's supposed Busang gold discovery in Indonesia was a hoax. Other Bre-X officials are not facing charges, however, even though court documents allege that they too sold shares in 1996. Michael Cowpland, founder of Ottawa-based software developer Corel Corp. and one of the best-known figures in Canada's high-tech sector, was charged in 1999 with selling \$20 million worth of shares in August, 1997, ahead of the release of disastrous quarterly financial results.

More recently, Andrew Rankin, the former managing director of mergers and acquisitions at the Royal Bank-owned brokerage, faces 10 counts of insider trading related to pending corporate mergers and acquisitions. His childhood friend Daniel Duic made approximately \$1.9 million from trading on Rankin's inside information. In a settlement with the OSC, Duic agreed to pay \$1.9 million and testify against Rankin if subpoenaed. The OSC is currently preparing for a criminal trial (Carr, 2004, March 5: B5). But these limited charges were not enough to convince the public that the securities commissions were willing and able to investigate illegal insider trading.

### ***Administrative Proceedings***

Some cases are settled without a hearing. In Ontario, the commissioners approve settlements at a hearing where the staff present the settlement. In BC, the staff enter settlements without formal approval by the commissioners. If the staff decide to proceed with a case, they bring it to a hearing panel. The administrative proceeding is a public hearing, ordered by the commission, and presided over by a tribunal panel of three commissioners. Some proceedings are lengthy and complex, with the presentation of numerous documents and witnesses; others proceed on the basis of a partial agreed statement of fact. The staff and enforcement lawyers appear before the hearing panel. The staff prepare a detailed report, stating the nature of the offence, the evidence, the recommended form of legal action and its justifications. The staff call witnesses and present related documentation supporting their evidence to the panel at the hearing. Then respondents call witnesses, and both sides present oral arguments before the hearing panel. The panel renders the final disposition in the case. If the respondents are

dissatisfied with the panel's decision in the case, they can appeal to the superior courts in their respective provinces.

The panel of Commissioners scrutinize the available evidence for weakness or inadequacy. The burden of proof in an administrative case of insider trading is the civil standard based on the balance of probabilities. The OSC in *George (Re)* (1999) quoted this standard by analogy with other administrative laws stated in *Re Bernstein and College of Physicians and Surgeons of Ontario* (1977, at 485-486) by Garrett J.:

I hold that the degree of proof required in disciplinary matters of this kind is that the proof must be clear and convincing and based upon cogent evidence which is accepted by the tribunal. I agree with Mr. Justice Schroeder that the burden of proof is to establish the guilt of the doctor charged by a fair and reasonable preponderance of credible testimony, the tribunal of fact being entitled to act upon the balance of probabilities. I think, however, that the seriousness of the charge is to be considered by the tribunal in its approach to the care it must take in deciding a case which might in fact amount to a sentence of professional death against a doctor.

In *In the Matter of Frederick Elliot Rosen* (1991, at 1093), Reid J. confirmed that this standard is one of the highest ones “of proof to be found outside the criminal courts.” The evidence presented by the Commission to establish the allegations “has to be of such quality and quantity as to lead the Commission, acting with care and caution, to the fair and reasonable conclusion that the alleged is guilty of the charge.” Reid J. also held that “the standard of proof rises with the gravity of the allegation and the seriousness of the consequences to the alleged offender.”

In examining the difficulties of proof in insider trading cases, two issues repeatedly emerged. First was the predictable problem of being able to find witnesses. In *George (Re)* (1999), staff of the Ontario Securities Commission alleged that on May 29,

1995, Gary George, as a director, trading officer and interim branch manager of Marleau Lesmire Securities Inc., attended a meeting of members of Marleau's institutional sales group. In the course of that meeting, one participant disclosed material information he had received from the CEO of Solid State Geophysical Inc.. George traded in securities of Solid State Geophysical Inc., at a time when he was in possession of this material information that had not been generally disclosed about the company. George acknowledged that he probably was at the meeting, but denied having heard this information. The Commission found that George had traded in securities of Solid State Geophysical Inc., but held that the evidence did not establish that he was in possession of the material information at the time he executed the trade. The Commission was not satisfied with the testimony by the co-director of research for Marleau, who was at the meeting, to the effect that George was present and had heard the information. The Commission held that,

We also have difficulty in understanding why someone in George's position, and being the sort of honourable person which all the witnesses ... said him to be, would have knowingly breached the Act for the rather paltry profit which he made on the short sale and purchase of Solid State shares.

Whether or not professional advisors such as brokers, bankers and lawyers assist investigations of insider trading can be crucial to the prosecution process. Regulators believe that advisors are generally cooperative, although concerned with protecting their clients. However, regulators feel that professionals could be more forthcoming than they generally are in assisting in insider trading investigations (Interview with the BCSC Executive Director, July 2002).

There are also problems in establishing that the information available to the trader was price-sensitive in that it was likely materially to affect the price of the security. Seemingly it is difficult to prove a violation relying merely upon circumstantial evidence that the trader was in possession of confidential information or connected to someone with such knowledge. It is not sufficient to show that the price of the securities subsequently rose or fell as a result of the information becoming available. In *In the Matter of Naxos Resources Ltd.* (1999), where Jimmy John, Sidney W. Kemp and Ian Gordon were alleged to have committed insider trading in Naxos stocks, the Alberta Securities Commission (ASC) held that a chart of Naxos share prices correlated to dates of press releases was not sufficient evidence to prove that Kemp or Gordon had traded in Naxos shares on non-disclosed material insider information. The Commission stated:

Such correlations were not always evident, indeed, share prices prior to or immediately after a number of supposedly significant press releases did not change significantly or reacted inversely to the nature of the information. No evidence was submitted as to the total volume of Naxos shares traded on or around specific dates of press releases. [at I (b)]

### ***Administrative Sanctions***

There are several administrative sanctions that might be applied in the context of insider trading or informing. They include cease trade orders, removal of exemptions, and prohibition from acting as a director or officer. The commissioners are also empowered to order the insider trading offender to pay all costs properly incurred by the commission in hearings and investigations. The commission may also apply an administrative penalty for the offence.

The aim of administrative sanctions was described in *Mithras Management Ltd. et al (Re)* (1988, at 1610), where the OSC stated with reference to various sections of the *Securities Act*, and was quoted in *M.C.J.C. Holdings (Re)* (2002):

[T]he role of this Commission is to protect the public interest by removing from the capital markets – wholly or partially, permanently or temporarily as the circumstances may warrant – those whose conduct in the past leads us to conclude that their conduct in the future may well be detrimental to the integrity of those capital markets. We are not here to punish past conduct; that is the role of the courts, particularly under section 118 of the Act. We are here to restrain, as best we can, future conduct that is likely to be prejudicial to the public interest in having capital markets that are both fair and efficient. In doing so, we must, of necessity, look to past conduct as a guide to what we believe a person’s future conduct might reasonably be expected to be; we are not prescient, after all.

There are several factors that influence the Commission’s decisions to impose administrative sanctions on insider trading offenders. In *In the Matter of M.C.J.C. Holdings and Michael Cowpland* (2003), the OSC commissioners held that three issues need to be considered when forming an opinion whether proposed administrative sanctions are appropriate. The commissioners quoted two of these issues from *In the Matter of Larry Woods* (1991),

The first ... is whether or not, assuming the conduct is objectionable, there is a reasonable likelihood it will be repeated. The second is whether or not the conduct of the respondents [the accused], if objectionable, is such as to bring into question the integrity and reputation of the capital markets in general.

The commissioners went on to say,

The third issue was referred to in the Théberge case: that is the issue of impact on the respondents. In determining impact, we need to consider all relevant factors in proportion to circumstances relevant to a respondent [the accused] to be sure sanctions are proportionately appropriate. Such factors may include in varying importance the following: the size of any profit (or loss avoided) from the illegal conduct; the size of any financial sanction or voluntary payment when considered with other factors; the

effect any sanction might have on the livelihood of the respondent; the restraint any sanction may have on the ability of the respondent to participate without check in the capital markets; the respondent's experience in the marketplace; the reputation and prestige of the respondent; the shame, or financial pain, that any sanction would reasonably cause to the respondent; and the remorse of the respondent. These are some of the factors that we believe may be relevant in various degrees. There may be others, and perhaps all of the factors we have mentioned would not be relevant in this or another particular case.

In this case, the OSC staff alleged that M.C.J.C Holding sold 2.4 million Corel Corp. shares worth \$20.4 million between 11 and 14 August 1997. Less than a month later, Corel announced that it would post a quarterly loss of US\$32 million, and its price fell sharply. By selling early, M.C.J.C. Holding avoided approximately \$10 million in losses. The OSC's three-member panel rejected a settlement of \$575,000 in penalties against President and CEO of Corel Corp. Michael Cowpland, and a two-year ban on his being a director of a public company, saying that the proposed penalties on the high-tech entrepreneur were not big enough to stop the "cancer" of insider trading. They noted that even at the lower figure, the amount was more than Cowpland would pay under the proposed settlement agreement. This proposed settlement with Cowpland would not have been enough to persuade the public that securities regulators are protecting the interests of investors. Surprisingly, however, in December 2003, the OSC finally accepted the settlement of \$575,000 in penalties from Cowpland, after four years of negotiations between the two parties [*In the Matter of M.C.J.C Holding Inc. and Cowpland* (2003)]. The OSC panel approved the settlement based on its new estimate that the insider trading saved Cowpland no more than \$1.4 million, which is considerably lower than earlier OSC estimates.



Although the OSC in the case of *M.C.J.C Holdings Inc.* (2002) case held that it should send a message to others that persons engaging in insider trading will not benefit from their illegal activity, it is generally agreed that the predominant objectives in imposing administrative sanctions on insider traders is specific deterrence. In *Seto (Re)* (2003, at 63), the ASC cited the B.C. Court of Appeal in *Cartaway Resources Corporation (Re)* (2002),<sup>67</sup> where the majority of the court held that the BCSC erred in addressing general deterrence when deciding the appropriate amount for an administrative penalty, because the public interest mandate of securities regulators only requires the consideration of specific deterrence when applying administrative sanctions. However, in *Seto (Re)* (2003), where the accused admitted purchasing 5,000 shares of Inter-Tech Drilling Solutions Ltd. with knowledge of undisclosed material facts, the ASC believed that a two-year director/officer ban, an administrative penalty of \$5,000 and a payment of \$10,000 for the cost of the investigation are not only appropriate for protective and preventive purposes but also “will incidentally provide a general deterrent effect” (at 65, 66).

Although the Commissions stated that their role is to protect the public interest, it can be argued that the public interest would actually demand that insider trading be eradicated and fully penalized. However, the complexities of a protracted trial coupled with the strict observance of procedures needed in such cases render an administrative settlement an attractive option. In most settlement arrangements the accused agrees to the penalty imposed without admitting or denying guilt. The Commission staff normally promise not to initiate any complaint or request the Commission to hold a hearing or

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<sup>67</sup> Appeal was heard and reserved by the Supreme Court of Canada on November 7, 2003 ([2003] S.C.C.A. No. 474).

issue any order in respect of any conduct or alleged conduct of the accused. This arrangement is said to be of benefit to both the accused and the Commission staff in terms of cost and time saved.

There are only a small number of settlements in which the accused has had to pay a substantial sum of money. The largest insider trading settlement in Canada is the one between the OSC and the founder and CEO of Laidlaw Inc., Michael DeGroote [*Seakist Overseas Limited et al. (Re)* (1993)]. The settlement document states that DeGroote et al. had knowledge that Laidlaw's earnings for the quarter ending December 1990 were unusually poor as of early 1991. In January 1991, Seakist opened an account with Midland (with Walker as broker), and between January and the following March sold short three million Laidlaw Glass B shares for \$61.2 million. The profit from the short sale was approximately \$16.5 million. DeGroote strongly denied in the settlement that he had traded on privileged information. In the settlement, the three men were banned from trading securities in Ontario for five years. DeGroote, Herbots and Seakist had to pay collectively \$23 million. Walker paid a fine of \$304,286 (equal to his commission on the short sale) and retired from the broker industry.

Another large insider trading settlement also took place in Ontario. In *Unicorp Canada Corp. (Re)* (1986), the actions of Unicorp Canada Corp. and Gordon Capital Corp., during Unicorp's bitterly contested takeover of Union Enterprises Ltd., resulted in a cash bid for a privileged group of institutional shareholders, and a lower-value share swap for others. Gordon was accused of improperly tipping information to certain clients and trading with undisclosed information. In a settlement with the OSC, Unicorp paid a

\$6 million penalty and Gordon paid \$1.1 million to compensate shareholders of Union other than Unicorp.

The settlement in *Seifert (Re)* (1999) also involved a relatively large sum of money. In this case, Michael Lee Serfeit, legal counsel to Arakis Energy Corporation, and Terry Alexander, former president of the company, admitted that they traded hundreds of thousands of dollars worth of Araki Energy shares with knowledge of undisclosed material facts. Serfeit was banned from the securities industry for 12 years and was charged \$450,000. Alexander was banned from trading for 20 years and fined \$1.2 million.

*Canadian 88 Energy Corp. (Re)* (1997) is a settlement case decided by both the OSC and the ASC. Here, the commissions alleged that Greg Noval had broken securities laws by buying Morrison shares with information that was not available to the public, and that Noval, president of Canadian 88 Energy, had agreed to deal with David DiPaolo in December 1996, just a few weeks before the takeover bid for Morrison was announced. Under the settlement agreement, Canadian 88 agreed to a reprimand, Noval was handed a one-year trading ban and West Central and DiPaolo each received a six-month trading ban. The respondents also agreed to pay the commissions \$200,000 to cover the costs in the matter.

In British Columbia in 1999, the BCSC completed the longest insider trading case determined by settlement in Canadian history, namely, *In The Matter Of Bennett et al.*(1999). In this high profile case, Herb Doman, the head of Doman Industries Ltd. (DIL), tipped former B.C. Premier William Bennett and his brother Russell Bennett to the fact that a proposed takeover of his company, by forest products giant Louisiana-Pacific,

had collapsed in November 1988. The Bennetts sold their 500,000 shares for a profit of almost \$2 million. In the final settlement after an 11-year legal battle, Herb Doman had to temporarily resign as CEO of his firm. Doman and the Bennetts were each fined \$333,000. For ten years, they could neither trade securities nor be officers of public companies.

The OSC states, in *M.C.J.C. Holdings Inc. and Michael Cowpland (Re)* (2002, at 1136), that one of the factors which should be taken into account was “the size of any profit (or loss avoided) from the illegal conduct.” In some settlement cases, nevertheless, the penalties imposed by the commissions for illegal insider trading are less than the profits generated from the offence. In many settlement cases, the accused had only to pay a small sum of money, i.e., \$2,500 to 50,000. In *Patterson (Re)* (2000), Patterson set up a trust in his name through a company based in Jersey in the UK. Through the trust, Patterson acquired Bray International. Between 1990 and 1996, David Michael Patterson directed Bray through his trust to buy and sell shares for a total cost of more than \$800,000 in Donner Minerals, Crazy Horse Industries, Allied Strategies and Zicor Mining where he was an officer or director throughout the 1990s. In the settlement with the BCSC, Mr. Patterson agreed to pay a \$50,000 fine. He was banned from the market for 15 months and had to resign any positions as an officer or director of a publicly traded company.

The *Rose (Re)* case (1997) involved Robert Frederick Rose, who was a promoter of Paragon shares and an employee of Canaccord Capital Corporation. In acting as an unapproved market maker in the securities of Paragon at the same time as he was

discussing and negotiating a private placement<sup>68</sup> on behalf of Paragon and Canaccord, Rose placed himself in a conflict-of-interest position against the public interest, and engaged in insider trading contrary to section 76 of the Act. A joint settlement agreement was reached. He was fined \$30,000 and banned from trading securities for two years.

The ASC, in the *Cartaway Resources Corp. (Re)* case (1999), alleged that Walter Nash, Vice-President of Exploration of Cartaway, with full access to the drill logs, information from the on-site geologist, inspection of drill core, etc., exercised options and purchased 50,000 Cartaway shares at a share price of \$0.72; he then sold all his Cartaway shares at an average price of \$9.15, for a profit of approximately \$420,280. A joint settlement agreement was reached. Nash was forced to resign all positions and pay an administrative penalty of \$25,000, and pay another \$25,000 to help defray staff's costs of investigation.

An insider trading was also made against Richard Théberge in the case of *In the Matter of Richard Théberge* (2001), who purchased 6,500 shares of CML Corporation at various prices after he got information from his father, Claude Théberge, that the company would be a takeover target. Claude Théberge served as the chairman of the board at the time of purchases. Richard Théberge sold the shares after the takeover announcement, making approximately \$15,000 in profit. In the settlement, Richard Théberge was reprimanded, and forced to cease trading for 120 days and to pay a fine of \$25,000 to OSC.

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<sup>68</sup> Raising of capital via the sale of securities to a relatively small number of private investors. Private placements often exist for the small business owner and are often less expensive and easier than taking the company public. This case involved a Paragon's private placement, arranged and negotiated by Rose, of three million special warrants at a price of \$2.75 per warrant for gross proceeds of \$8,250,000, which was a material change in the affairs of Paragon. Therefore, Rose's trades in securities of Paragon in his capacity as a market maker, prior to the announcement of this material change, constituted insider trading.

In *Kates, Paul A. (Re)* (1992), the OSC Staff accused director Paul Kates of selling Standard's stock before the public was told of problems at its trust arm. The allegation was part of a broader probe into accusations that Standard had issued misleading financial statements before it collapsed that year. Mr. Kates paid a \$12,000 penalty as a part of a settlement and was banned from acting as an officer or director of any public company for two years.

Another alleged insider trading case concerned Paul Penna, President of Agnico-Eagle Mines Ltd., Goldex Mines Ltd. and Mentor Exploration and Development Co. Ltd. [*Mentor Exploration and Development Co. Ltd. and Paul Penna (Re)* (1992)]. Here, Penna pleaded guilty to buying 6,000 shares and 9,500 warrants of Goldex Mines Ltd., an affiliate of Agnico-Eagle, using undisclosed information. In addition to the fine of \$5,000 by the court, he also reached a settlement with the OSC to make a voluntary contribution of \$2,500 to defray a portion of costs incurred by the OSC.

Also charged was George Hariton, an officer of Bell Canada [*In the Matter of George Hariton* (1994)]. Hariton was advised of the termination of negotiations between Bell, BCE and SHL. He traded on this undisclosed information and made a profit of \$1,100. A joint settlement agreement was reached between him and the OSC. He was barred from trading for six months and ordered to pay \$3,300.

The *Brewer* case (2003) involved Lloyd Brewer, who was a director and vice-president of explorations of St. Elias Mines Ltd. St. Elias had received raw assay results on a mineral prospect in northern Peru that were far below the trench excavation results announced in a news release. With knowledge of the inside information, he sold 15,500 shares and avoided \$1,940 in losses by trading prior to the disclosure of the assay results.

In the settlement, Brew agreed to make a voluntary \$6,940 payment to the BCSC. He also received a two-year prohibition from becoming or acting as a director or officer of any reporting issuer.

Sometimes an insider trading offender would receive nothing but a certain period of trading prohibition. In *Mitton (Re)* (1988), Janet Mitton, a director of Maximus, admitted that she had facilitated breaches of the *Securities Act* by her husband Michael Mitton, including illegal insider trading in the shares of Maximus. She had informed her husband of certain undisclosed material facts in the affairs of Maximus. In the settlement, Janet Mitton received an enforcement order in which she was prohibited from acting as a director or officer of any B.C. company from November 1, 1988 to October 31, 2008. However, this prohibition clearly did not deter the accused from violating the law, because Mitton was charged again under the B.C. Offence Act with breaching the enforcement order on January 27, 1997 [Weekly Summary, Edition 88:101 (BCSCn)].

Another example was the case of *In the Matter of Maxwell et al.* (2000), where three men were accused of insider trading and filing false financial statements for Megalode Corp. a Toronto stock promotion. Maxwell sold 200,000 Megalode shares for \$603,000 and sold indirectly 492,900 Megalode shares held by his wife for \$4,828,596, while Mr. Candido sold 70,000 shares for \$44,718. The case was first dismissed on 7 December 1996. The OSC later recharged the defendants who signed settlements in 1999. The three men admitted the insider trading allegations. Dzambazov was prohibited from trading for six years, Candido for eight years and Maxwell for ten years. They were also prohibited from acting as directors or officers for ten years.

In *Robinson (Re)* (1996), Terence Robinson, a Toronto stock promoter, was charged with illegal insider trading in connection with three over-the-counter penny stocks. The OSC imposed a lifetime trading ban against him for market manipulation. His appeal to the Ontario Superior Court of Justice was dismissed.

In a few settlement cases, the accused received only a reprimand. For example, in *In the Matter of Martin Shefsky* (1999), Shefsky was the trustee of Toreal, a company which held shares of Evans. On August 25, 1993, Evans gave FoxMeyer Corp. options to purchase up to five million shares of Evans at \$1.50 per share. Before this information was publicly disclosed, Toreal made 15 trades on Evans shares. It also did not file insider trading reports. A joint settlement agreement was reached, in which the accused was only reprimanded.

While in most settlements the trading or director/officer prohibition time is normally less than two years, there are a few exceptions which mostly happened in British Columbia. It seems that a longer time prohibition tends to take place in settlements where the accused does not pay a large sum of money to the commission. In the BCSC case of *Slightham (Re)* (1995), Slightham, president, CEO and a director of Beauchamps and president and a director of Beaufield, traded in the shares of Beauchamps and Beaufield with the knowledge of undisclosed material facts or material changes which had not been generally disclosed. In the settlement, Slightham was prohibited by the BCSC from being a director or officer of any reporting issuer, or of any issuer which provides management, administrative or consulting services to a reporting issuer, for 25 years. Slightham also paid the sum of \$30,000. Similarly, in another BCSC case of *Ayre (Re)* (1996), Calvin Edward Ayre, a director and President of Bicer Medical



Systems Inc., knowing of material facts or material changes, purchased and sold in excess of 4 million Bicer shares. In the settlement, Ayre consented to orders banning him from the market for 20 years. He also agreed to pay \$10,000 to the BCSC.

When the accused chooses not to settle with the regulator, the commission panel will hold a hearing to decide liability and possible administrative sanctions. Since the staff normally prefer a compliance approach in their enforcement, an unreasonable disparity may happen between the sanctions meted out to the accused persons by way of settlement and those dispensed against individuals who did not make any sort of “voluntary payment.” In four non-settlement decisions in B.C., for example, the offenders each received 10 to 25 year trading or director/officer ban from the BCSC, in addition to a payment. In *Aatra Resources Ltd. et al. (Re)* (1993), Henry Huber engaged in improper insider trading and made a substantial profit, by selling his 40,000 Aatra shares with knowledge that the distribution had collapsed. Huber was prohibited from becoming or acting as a director or an officer of any issuer for a period of 10 years. His registration was cancelled. He also had to pay prescribed fees or charges for the costs incurred by the Commission and the then Superintendent.

In *Hunter (Re)* (1995), James Jonathan Hunter, a newsletter publisher who promoted speculative investments, engaged in illegal insider trading in Cal Graphite Corp. shares, by selling shares with knowledge of undisclosed material facts, namely his agreement with John Murray Stirling, former president of Cal and his option with Handelskredit Bank AG. The BCSC imposed a 10-year prohibition from trading securities and from being a director or officer of a company on Hunter. Hunter was also ordered to pay the costs of the hearing.

In *Pinchin (Re)* (1996), Pinchin conducted undisclosed takeover bids of Consolidated Brightwork Resources Inc. and Keywest Resources Ltd. During the periods, he purchased and sold shares of Brightwork and Keywest with knowledge of such undisclosed material changes. The BCSC imposed 25-year trading ban and 25-year director/officer ban on Pinchin. He was ordered to pay a \$50,000 administrative penalty. He and his two companies also paid \$54,723.38 in costs.

The different treatment between settlement and non-settlement cases has even been criticized by the courts. In *Donnini (Re)* (2002), the Ontario Divisional Court held that the commission panel should not impose an increased penalty on a person because he or she chooses to defend himself or herself, and has not reached a settlement with the commission. In this case, the OSC charged Piergiorgio Donnini, Yorkton Securities Head Trader, with insider trading in shares of Kasten Chase Applied Research. Donnini received a 15-year suspension from the OSC panel for illegal insider trading and was ordered to pay \$186,000 in costs, partly because he refused an offer of a five-year trading ban from the OSC. The chairman and CEO of Yorkton Securities Scott Paterson, who was the person in charge of this entire deal, received only a two-year suspension, because he settled with the Commission by paying \$1 million. On appeal [*Donnini v. Ontario Securities Commission* (2003), at 33], the Ontario Divisional Court upheld the Commission's finding of liability, but reduced to four years the suspension. However, the OSC staff still plan to seek leave to appeal the Court's decision (No Author 2004: FP02).

In short, improper insider trading seems to be condoned by the commissions as a relatively victimless crime, compared with stock manipulation, or direct conflicts of interest among mutual funds dealers. The relatively light administrative sanctions seem to

be relatively ineffective in deterring offenders and potential offenders. Except in a rather small number of cases, those who have appeared at public hearings before the commissions during the 1990s have for the most part been little known outside the investment industry – penny stock dealers, individuals selling securities without a prospectus, and mutual fund salespersons. Some commentators criticized that the commissions had the tools to pursue offenders, including broad powers to subpoena documents and witnesses, but were unwilling to strengthen their enforcement (Howlett, 1999, October 20: B1). Fortunately, the commissions have recently decided some high profile cases, including the *Cowpland* case. However, it is still unclear how far the regulators will go in this direction.

### ***Criminal Prosecution***

As discussed above, routine decisions are made not to proceed criminally where insider trading behaviour has obviously occurred. If the staff find a matter which involves a criminal or quasi-criminal offence, there is no guarantee that a criminal prosecution of the offender will be brought. The assumption of securities commissions is that normally compliance through cooperation of businesses is more important when dealing with insider trading offences. Prosecution is regarded as superfluous if businesses will voluntarily introduce genuine safeguards to avoid wrongdoings. Criminal proceedings are seen as a backstop to be used where warnings of compliance have failed, or for unscrupulous offenders which are immune to other reformatory action. In this view, the number of prosecutions is not the primary standard for evaluating a securities regulator, and its success is better judged by their absence. Prosecution is an admission of defeat,

for other means must have failed in preventing insider trading malpractices. The BCSC

Executive Director summarized these sentiments to me as follows:

Well, my view of it is that insider trading is a regulatory problem. And our job as a regulator is to deal with important problems and try and correct them, and that involves, invariably, changing behaviour, changing people's behaviour in the marketplace.... the trouble with [criminal] enforcement is [that] it is what I call an "after the fact" tool. It's dealing with yesterday's news, right? We would be putting people in jail for infractions that they committed two years ago, basically - at the best. You look at the cases that come up now - they all involve trading that took place years and years ago. So what's happened in the interim, while these cases were waiting to go to trial? More insider trading. When you want to change behaviour in the market, I think you need to look beyond just [criminal] enforcement. And by that, I mean there are lots of other tools that we can employ. One of which would be a program of requiring industry to help us about insider trading. We call that "partnering" with industry. To give you an example, at the organization I used to work for, I used to be required as an insider to file all my broker's reports with the Compliance Department. So, every month, the Compliance Department would get my broker's reports and they would see the trading that I had done in all my holdings, not just the stock. And I found that quite intrusive, but they argued 'how else are we going to know if you've breached our rules with respect to insider trading?' And this was the company itself ... the company was just sufficiently concerned about its vulnerability to some of its senior people trading, either deliberately or inadvertently, in its stock that they wanted to control it. And so, industry has a role to play in what I call prevention, and also in detection and deterrence - a much stronger tool. A company, the issuing company whose shares are of concern here, they were taking responsibility for ensuring that their insiders, at least employee insiders, were not going to embarrass the company by getting caught trading in the shares at a time when they shouldn't have. And so they, they themselves - the company - imposed restrictions on their insiders that they enforced (Interview with the BCSC Executive Director, July 2002).

However, this view has never been supported by empirical evidence. In contrast, a task force recently reviewed compliance manuals of several major investment firms in Canada and found that only one firm had written procedures in place to prevent confidential information from leaking out (Illegal Insider Trading Task Force 2003: 16).

The argument for a compliance model cannot be separated from the fact that it is usually difficult to achieve criminal prosecutions. In Canada, different provinces have different practices as to who is responsible for instituting criminal prosecutions against insider trading offenders. The British Columbia Securities Commission remains unable to lay criminal charges against insider trading and other types of securities offences. Criminal charges can be laid only by or with the approval of the Attorney General. The BCSC attempted to overcome this problem by launching a partnership with Crown prosecutors through the Securities Fraud Office (SFO) in 1995. This project, modelled after the Securities Fraud Office at Scotland Yard in England, was launched to bring securities investigators, police and Crown prosecutors into a single office to investigate and prosecute securities crime. The BCSC agreed to provide the SFO with \$1 million a year to fund a three-year pilot project. The SFO was composed of two commission investigators, five RCMP investigators and five Crown prosecutors. However, the BCSC complained that the Crown prosecutors had set too high a test for pursuing particular cases, and thus withdrew their support in October 1998, just after the three-year period expired. The office was finally shut down on March 31, 1999 because the experimental partnership did not work. In an interview with Vancouver Sun reporter David Baines, Sasha Angus, the BCSC's Director of Enforcement, said that the fraud office "didn't achieve what it needed to achieve" to justify continued funding (Baines 1999: D18). This initiative generated only a handful of convictions on relatively minor charges (Baines 2003: E5). The OSC and the ASC have the authority to initiate criminal prosecutions under their provincial securities acts. However, cooperation is still common between the Crown and the Commissions in these two provinces.

To obtain a conviction for trading on inside information under most Canadian securities acts, the Crown or the Commission must prove that a) the accused was in a “special relationship” with the reporting issuer of the securities, b) the accused purchased or sold securities of the reporting issuer, c) the accused made the purchase or sale with knowledge of material information concerning the affairs of the reporting issuer, and d) the material information had not been generally disclosed. To obtain a conviction for informing another of inside information, the Crown or the Commission must prove that a) the accused person was in a “special relationship” with the reporting issuer, b) the accused informed another person of material information with respect to the reporting issuer, and c) the accused informed another person of the material information before it was generally disclosed (Johnston and Rockwell 1998: 141-142).

In criminal cases, the standard of proof required is “beyond reasonable doubt,” which is much higher than the civil standard of proof upon the balance of probabilities. Circumstantial evidence may not always meet the “beyond reasonable doubt” threshold for criminal convictions. Accordingly, the difficulty in obtaining direct evidence makes the pursuit of criminal sanctions very burdensome. Instead, administrative sanctions, which have the lower standard of proof, are typically pursued.

The difficulty in proving an insider trading case in criminal prosecution was explained by the Executive Director of the BCSC in my interview with him:

Another challenge is that it's very hard to get evidence. It's very hard to get evidence that insiders - who you can prove traded the stock - it's hard to get evidence that they did it in the knowledge of some event that was about to happen. Most of the time, that is circumstantial ... we can get cases decided on circumstantial evidence, but the circumstantial evidence has to be strong. It has to be beyond a reasonable doubt. To prove beyond a reasonable doubt that the insider traded on the basis of knowledge that

he had that was not in the market at the time that they traded. And the third thing is that ... it's often difficult to prove how much the individual benefited. Like, there are two kinds of insider trading: one is before a big positive announcement comes, somebody buys the stock and they make money when the stock price goes up. And you can argue "you made all this money." The other type is they know something bad is going to happen and they sell, right? So then, you can't prove that he made anything, but you can prove that he avoided losses. Now, you also have to prove that the market was harmed by them doing that. And so, there has to be a substantial gain or a substantial loss avoided in order to prove there was market harm in doing that. Most of the cases we see are relatively small - they didn't have any impact on the companies' stock prices. It's really hard to argue that the market was harmed and therefore, you know ... the system ... the judges will say "why are you bothering? It's unclear that all the circumstantial evidence that you presented leads you to the incontrovertible decision or conclusion that he did, and now, on top of all that, there wasn't much market harm, anyway. So why are we bothering?" (Interview with the BCSC Executive Director, July 2002)

Commenting on the judicial response to insider trading, a Vice-Chair of the British Columbia Securities Commission stated in an interview, "the courts traditionally in this jurisdiction (British Columbia) have been ... reluctant to convict on insider trading" (Interview with a BCSC Vice-Chair, July 2002). Given the courts' reluctance against insider trading, the securities commissions' role as regulator has become even more difficult.

In *R. v. Bennett* (1989) the Crown alleged that Herb Doman, William Bennett, and his brother Russell Bennett traded shares with inside information of a potential arrangement with or takeover of DIL by Louisiana Pacific Corporation (LPC), a major U.S. company. Immediately after LPC advised that LPC was terminating the negotiations, telephone records showed an outgoing call from the DIL office to the McIntosh where the Bennetts had their offices. The Crown alleged that this call was from Herb Doman to either Russell or William Bennett, telling one or both that the LPC deal was off, with the consequence that it was a tip of undisclosed material information. There

was other circumstantial evidence. For example, the Bennetts both borrowed uncharacteristically heavily to purchase DIL shares in the months after LPC expressed interest in DIL. Therefore, the allegations were that Herb Doman had tipped inside information to the Bennetts, and that all three were thus insiders who traded while in possession of inside information.

Craig J. of the B. C. Provincial Court was not satisfied by the evidence of phone records which could not confirm which persons were involved in the conversations. He held that the Crown had not proved its case beyond a reasonable doubt. According to Craig J., “there was no direct evidence of Herb Doman and Russell Bennett speaking with each other on the dates particularized. Further, there was no basis at all for an inference to be drawn from circumstantial evidence that Russell Bennett made his purchases of DIL shares between August 24, 1988 and September 20, 1988, as a result of specific insider information given him by Herb Doman” [*R. v. Bennett* (1989)].

The Vice-Chair of the BCSC was clearly not satisfied with this judgment in the interview but celebrated the BCSC’s successful administrative action against Doman and Bennett brothers. She stated:

... I have to agree that the cases are very difficult to prove, but I think they certainly get more convictions in the United States than they do here, maybe we have a much smaller market... They were charged criminally, and they were acquitted, and we decided, because we felt the evidence was sufficiently strong, we felt that they were improperly acquitted; but, having said that, we decided that it was such an important case that we needed to pursue it vigorously. And it was hotly contested, and it went all the way to the Supreme Court of Canada. But we were successful in finding, on administrative proceedings, which is a ‘balance of probabilities’ burden of proof, as opposed to ‘beyond a reasonable doubt,’ we found that there had been illegal insider trading. One of the advantages that we have over the courts is, of course, that we can interview and force targets - you know, potential respondents - to testify. And of course, in the



criminal courts, they're not compellable, but before us, they are. And so, one of the advantages that we had in the Bennett hearing is that we compelled the respondents to testify, and many of the Commission's findings turned on issues of credibility - they didn't believe their story. So, and that case was really fought on every level - I mean, they spent a lot of money on fighting us at every level of the Supreme Court, the Court of Appeal and the Supreme Court of Canada. But eventually we prevailed (Interview with a BCSC Vice-Chair, July 2002).

Some regulators believed that if the standard of proof were to be lower the prosecution would become easier, but many had doubts about the wisdom of taking this approach. If a civil standard of proof on the balance of probabilities was introduced, many regulators feared that the sanction of imprisonment would have to be abandoned. This is seen to be inadvisable because the principal deterrent would then cease to exist.

A number of regulators added that even if a civil standard of proof were to replace the current standard, you would still need to obtain the evidence and prove the elements of insider trading. It is worth mentioning that in *R. v. Bennett* (1989), Craig J. even went so far as to say that,

The prosecution has failed to prove, even on a balance of probabilities, that Russell Bennett was guilty of insider trading in making those purchases...Not only has the prosecution failed to prove beyond a reasonable doubt that Bill Bennett's sale of DIL shares was as a result of Herb Doman giving him insider information, it has established at least on a balance of probabilities that he made the decision to sell his shares and instructed his broker to do so before he could possibly have received any alleged tip.

Tomasic (1991: 121) suggests at this point that "rather than lowering the standard of proof, a more effective strategy might be to reverse the onus of proof for insider trading, to require the accused to prove that his or her conduct did not fall within the terms of the Act." Tomasic's suggestion is based on the grounds that "the matters raised by way of defence are usually peculiarly within the knowledge of the accused," and that

"spurious propositions may be advanced by the defence which almost any amount of prosecutorial resources will not be able to negate" (Tomasic 1989: 136). Such a solution, although it could well be a pragmatic and short-cut key to prosecutorial difficulties in insider trading cases, may also create some Charter problems under Canadian constitutional law. Some regulators perceive a need to educate the judiciary whilst others see the judiciary as lacking a grasp of the nature of market realities in this area.

To prove a violation, the likelihood that the information will materially affect the price of those securities should be apparent at the time of dealing. The definition of materiality is the key factor in deciding whether a company or its officials have stepped outside the rules of the securities legislation. However, there is no clear definition of materiality in the existing provincial securities statutes. In terms of the *Securities Act*, a material fact is "a fact that significantly affects or would reasonably be expected to have [significant effect] on the market price or value of such securities." A material change is "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable" (Canadian Securities Administrators 2000: 1). The looseness of the materiality requirement is a serious defect in the current legislation and as this dissertation shows, it is necessary to spell out more precisely what is meant by "material fact" and "material change."

In determining the meanings of "material fact" and "material change," evidence has a particularly critical importance, because of the conspiratorial nature of the actions

of the persons involved in this offence. One dimension of this problem of evidence is the need to find expert witnesses who can help establish that the information used was price sensitive. In *R. v. Harper* (2000), to consider whether or not the results of the 800 soil samples and the Teck trench samples constituted material facts,<sup>69</sup> Sheppard J. held that the materiality can be found from both the investor or potential investor's viewpoint and the geologist's perspective. The Court accepted expert evidence that these results were "material" within the meaning of the *Securities Act*. It contrasted Harper's failure to disclose these results with his eagerness to report earlier, positive assay findings, and noted the close timing between Harper's learning of the results and his share sales. The Court rejected evidence from both Harper and his project geologist that the information was not significant and did not undermine previous results.

In addition, to prove "material change" is even more difficult. The distinction between "material fact" and "material change" was highlighted in the case of *Pezim v. British Columbia (Superintendent of Brokers)* (1994). The Superintendent (the BCSC's chief administrative officer) alleged that the three directors and senior management of Prime and Calpine, two companies listed on the then Vancouver Stock Exchange, had violated the timely disclosure and insider trading provisions in three categories of impugned transactions: the drilling results and share options transactions, the private

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<sup>69</sup> Glen Harper's company Golden Rule Resources Inc was a junior exploration company listed on the Toronto Stock Exchange. On November 26, 1996, the company had released initial assay results from the first soil samples on a property in Ghana showing a high level of gold. On January 2 and 3, 1997, Mr. Harper received the results of the next 800 samples, which showed very low levels of gold and were not consistent with the initial samples. Harper decided not to release the results of these assays to the public, and instead continued to issue favourable press releases based on the results of the initial positive assays. In March 1997, Mr. Harper received the results for an additional 37 samples from Teck Corporation of Vancouver, which again showed low gold levels. Again, he did not release these results. During the period Jan. 3 to May 6, 1997, prior to the release of the results of the 800 samples and the Teck trench samples, Harper sold approximately \$4 million worth of his shares in Golden Rule. See *R. v. Harper* ([2000] O. J. No. 2791).

placement, and the ALC firm's withdrawal in contractual terms. The three accused persons were prevented from having information relative to assay results by a "Chinese Wall." The Commission concluded that undisclosed drilling results could constitute a material change in the affairs of a reporting issuer. Locke J.A. of the Court of Appeal agreed. Lambert J.A., however, writing for the majority of the Court of Appeal, was of a different view. He held that information obtained from assay results could not constitute a material change:

In my opinion, geological information obtained from observations of visible matter and geological information from drill cores in the form of assay results, or in the form of a properly plotted plan prepared from the results of a number of assays, are all capable of being material facts. Let us assume that the geological information relied upon by the Commission constituted material facts in this case. That does not mean that the same geological information constituted material change. In my opinion, geological information of the nature obtained on a continuing basis as a result of a planned drilling program does not constitute a change in the business, the operations, the assets or the ownership of the issuer; no matter what information is obtained from the drilling results. Such information may constitute a basis for a perception that there has been a change in the value of an asset. But that is a far different thing than a change in an asset.

Anand et al. (1999: 209) strongly criticized this view and agreed with the Commission's approach, stating that Lambert J.A.'s judgement is inconsistent with the economic and regulatory realities the securities legislation sets out to address. These authors also argued that from the point of view of investors, new information relating to a mining property (which is an asset) bears significantly on the questions of that property's value.

Since the law prohibits trading by insiders "with knowledge of a material fact or change," the Crown or the Commission also has the burden of proving "knowledge"

beyond a reasonable doubt. In order to commit the proscribed act, the insider must not only have traded while in possession of undisclosed material information, but he must also have used that information in making the trade. In *R. v. Woods* (1994), Farley J. of the Ontario Court of Justice held that insider trading is an offence of “strict liability,” rather than a true criminal offence requiring full *mens rea* on the one hand, or an offence of absolute liability on the other.<sup>70</sup> Therefore all of the common law defences of due diligence and reasonable mistake of fact together remain available.

In *R. v. Fingold* (1996), David Fingold was charged with trading shares in Cineplex Odeon following a meeting of the Board of Directors of Cineplex Odeon Corporation on February 25, 1989. At that meeting, the 1988-year-end financial statements and fourth quarter financial results were discussed. There was also exhibited at the meeting a significant level of disagreement between the management group and the directors representing the major shareholders. A public announcement of the financial results was not made until after the close of the markets on March 22, 1989. Although the financial results made known to the directors would be reasonably expected to substantially affect the market price, Babe J. of the Ontario Court of Justice (Provincial Division) rejected the Crown’s position that the definition of materiality is wholly objective, and instead accepted David Fingold’s own statement that he did not believe

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<sup>70</sup> In Canadian criminal law, offences are classified into true crimes, strict liability offences and absolute liability offences, depending upon the degree of fault necessary to prove the offence. For true crimes, the required degree of fault would be full *mens rea* in the form of intention, knowledge or recklessness. For strict liability offences, only negligence is required. Once the prosecution has established that the accused is the responsible party, the accused has the opportunity to raise a defence of due diligence. The absolute liability offence requires only that the prosecution prove that the accused person is responsible for the offence. There is no need for the prosecution to prove that the accused had a guilty mind. The defence of due diligence is not available for absolute liability offences.

that these results would substantially affect the market price. Fingold was acquitted in this case.

To obtain a conviction for insider trading, the Crown or the Commission should also prove that the material information had not been generally disclosed. One important question here is whether selective disclosure<sup>71</sup> of the material information constitutes public dissemination of the information. In *George* (1999), the OSC did criticize the practice of company executives passing material information to analysts without informing the public. However, there has been no precedent that particularly deals with this issue by the courts. In October 2000, Air Canada, acting on legal advice, provided certain analysts with information that led some of those same analysts to lower their recommendation on Air Canada stock. In the aftermath, more than \$200 million of Air Canada's stock value was sold off by the market. The company claimed that the information it gave to analysts was already known to the market and that it was surprised by the negative reaction. Others suggested that Air Canada took advantage of a legal loophole to avoid issuing a profit warning to the markets. With Air Canada stock dropping \$1.75 to \$13.25 after the message to analysts, Michael Watson, the head of the OSC's enforcement division, said that in general such stock price changes after the

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<sup>71</sup> Selective disclosure refers to the practice of disclosing material, non-public information about an issuer of public securities, made by the issuer or its agents, to selected groups or individuals, usually financial analysts, before disclosing the information to the public at large. In Canada, selective disclosure attracted attention in 1995 when The Toronto Stock Exchange Committee on Corporate Disclosure (the "Allen Committee") released its Interim Report. The Allen Committee acknowledged that it is important for corporate insiders to meet with financial analysts in "fostering open and thorough continuous disclosure practices." The Allen Committee recognized that "benefits may flow to the markets from the legitimate efforts of securities analysts who use their professional expertise to process detailed data and information into commentary that investors find useful and can digest relatively quickly and improve the flow of corporate information into the marketplace." However, the Allen Committee was concerned that private meetings with financial analysts and other professionals had resulted in "selective disclosure of information that should have been disclosed on a general basis." "Quite apart from any questions of compliance with securities laws," the Allen Committee asserted that selective disclosure causes "unfairness in the marketplace."

information could be considered evidence in any case, but it would not constitute proof (Marr 2000). In the agreed settlements with the OSC and the Quebec Securities Commission (QSC), Air Canada was ordered to pay a total of \$1 million to the two commissions (James 2001). Watson said that the enforcement division is pushing for a legislative prohibition on selective disclosure in order to investigate more insider trading cases. The corporate disclosure survey conducted by the OSC Staff in the Continuous Disclosure Team indicates significant acknowledgement of the use of selective disclosure of material information (OSC 2000). Therefore, if selective disclosure could be prohibited as ordinary tipping and insider trading, there could be many more insider trading cases prosecuted before the courts.

### ***Criminal Penalties***

Available criminal penalties for insider trading include prison sentences, probation and fines. According to the courts, the predominant sentencing objectives in a criminal case of insider trading are general deterrence and denunciation. These considerations were illustrated by Sheppard J. in *R. v. Harper* (2000, at para. 12):

As in criminal matters, in quasi-criminal offences of this nature, the sentencing principles to be applied are designed to prevent like occurrences and like initiatives by others. They are designed to encourage respect and support for the law and a just and orderly society and in this case securities industry. Canada (and Ontario) should not be jurisdictions of choice for those wishing to engage in insider trading. To achieve this and the other principles set out above, the Court must denounce and repudiate the unlawful conduct; it must deter the accused from repeating that unlawful conduct; it must deter others who hear of these charges and this sentencing from repeating the impugned conduct; it must assist in the rehabilitation of the offender and make the offender feel accountable to the specific, in this case, investment community and the community and society in general.

However, looking at the increasing insider trading illegalities in the markets, whether or not the criminal penalties imposed by the courts have a general deterrent effect is open to doubt (McNally and Smith 2003: 125). The most common criminal sanction was a fine, ranging in magnitude from \$1200 to \$2,000,000. Some of the cases where fines were imposed by the courts were the following:

- In *OSC v. G. Condy and W. Meyer* (1991), Gloria Condy, a secretary at Maple Leaf Gardens Ltd., bought about one hundred shares before a public announcement of a \$2.75-a-share dividend for Gardens shareholders. The stock price subsequently rose and Condy made a profit of approximately \$700. Winston Meyer, a broker at Wood Condy Inc., was fined for buying the shares for Gloria Condy because he knew the order was based on insider information. Condy pleaded guilty in Ontario Provincial Offences Court. Condy and Meyer were each fined \$1,200.
- In *OSC v. Mentor Exploration and Development Co. Ltd. and Paul Penna (Re)* (1992), President Paul Penna of Agnico-Eagle Mines Ltd., Goldex Mines Ltd. and Mentor pleaded guilty to buying 6,000 shares and 9,500 warrants of Goldex Mines Ltd., an affiliate of Agnico-Eagle, using undisclosed information. He was fined \$5,000 by the court.
- In *OSC v. L. Saliga* (1992, unreported court case), Ignac Saliga pleaded guilty to using insider information to buy stock in Corby Distilleries which had been targeted for takeover in 1989 by distiller Hiram Walker. Saliga made a total profit of \$18,387.50. The charges were dropped following a closed-door meeting between defence lawyers and a



prosecutor for the OSC. A fine of \$36,000 was imposed on Mr. Saliga by the court (Hornberger, 1992, June 11: A3).

Although rare, it is worth noting that even if the accused pleads guilty to insider trading offences, the court may still acquit him or her. In *R. v. Maxwell* (1996), former Megalode president David Conforzi originally pleaded guilty, on September 11, 1996, to illegal insider trading and publishing misleading financial statements. He avoided a loss of about \$321,000 in 1993 and 1994 by selling shares of Megalode, an over-the counter stock promotion. Conforzi and two other men were ultimately acquitted the same year of illegal insider trading. The reason was that the OSC had laid charges under an outdated version of the Ontario *Securities Act*.

A prison sentence is generally considered to be the last resort. Some of the primary factors that influence the judicial decision to sentence an offender to imprisonment are the type of offence, its gravity, and the character and position of the offender. If the defendant profited personally from his or her illegal conduct, judges are also more inclined to impose a jail term. Until the recent case of *R. v. Woods*, however, prison sentences had not been considered by the courts.

The defendant Larry Woods, formerly a senior executive at the bankrupt Plastic Engineering Technology Corp., was found to have recommended short-selling Petco shares to friend and business associate James Richardson, a former federal Liberal cabinet minister. Woods was believed to have known that Petco was in dire financial circumstances, but the full extent of Petco's financial troubles was not known publicly. In the original case [*Her Majesty the Queen v. Plastic Engine Technology Corporation et al.* (1991)], where Woods was found guilty of illegal insider trading, the trial judge Young J.

of the Ontario Court of Justice (Provincial Division) declined to impose a jail term and ordered the defendant to pay a fine of \$15,000. In his reasons for sentence, Young J. held that the defendant's conduct was serious and deliberate. However, he considered the lack of direct profit to the defendant as a mitigating circumstance and accepted public disgrace as an alternative to specific deterrence. He said,

I am satisfied that Mr. Woods committed this offence, mainly to assist his friend James Richardson limit his loss on his loan to PETCO and not to profit personally from his actions. Mr. Woods' improper conduct was discovered and he has been convicted. Disgrace for Mr. Woods in the business community has followed his conviction. As a result of this prosecution I doubt that Mr. Woods will commit such an offence again. Consequently, specific deterrence is not as important as it might otherwise be.

If the defendant had profited personally from his illegal conduct, I would have been more inclined to impose a jail term. I believe that general deterrence can be effected in this case by imposing a stiff fine rather than imprisonment which is generally considered to be the last resort. Given that the maximum fine has been increased in recent years from \$2,000 to \$1 million, I believe that the appropriate fine in this case taking into account the accused's personal circumstances, is \$15,000 and that amount is imposed (at para. 12-13).

This sentence was, at least in part, very badly reasoned and leaves the distinct impression of a too lenient judiciary towards white-collar crimes. This decision was, fortunately, effectively reversed on appeal. In the fascinating appellate decision, there was a bold attempt by Farley J. of Ontario Court of Justice (General Division) at first instance to give the legislation some real teeth by imposing a jail term for insider trading. The reasoning of Farley J. is somewhat more convincing than that of the trial judge. The learned judge Farley J. held that the breach of public trust by Woods, to the general disadvantage of participants in the stock markets, dictated a more severe penalty in the circumstances than the trial judge had imposed. He emphasized that "when one actually

trades with the benefit of insider information, then this seller is not an innocent and lucky winner. Rather the insider trader is a rapacious thief.” In imposing a 90-day jail term, Farley J. stated [*R. v. Woods* (1994)]:

I am also of the view that general deterrence requires a form of imprisonment even if this is a case in which the cash benefit does not end up directly in Woods' pocket. It is entirely possible to reflect that Woods' position of merely helping out an old friend could be abused by others who would structure their own abuse of the system to incorporate such a diversion. In the circumstances I think it appropriate to impose a sentence of 90 days' imprisonment on Woods instead of the fine, which sentence may be served intermittently (at para. 107).

Sheppard J. of the Ontario Court of Justice supported this view in his decision in *R. v. Harper* (2000). Here the defendant Glen Harper was the President, CEO and Chairman of Golden Rule Resources Ltd.. The evidence indicated that on January 2 or 3, 1997, Harper had received negative gold assay results from the Company's mineral interests in Ghana, and that on March 12, 1997, Harper had been given further negative assay results. Neither set of results was disclosed to the public during the relevant time period. The evidence also established that, rather than disclosing this material information to the public, the defendant held it back from public view. At the same time, between January 3 and May 6, 1997, Harper sold approximately \$3 million in Golden Rule shares for his own or his immediate family's personal gain. Sheppard J. held that the aim of general deterrence required a form of imprisonment in this case. He followed the sentencing principles in the Woods' case and imposed a sentence of one-year imprisonment. He also imposed a fine of \$3,951,672, by employing the loss-avoided

calculations under s. 122(4) of the Ontario *Securities Act*.<sup>72</sup> The reasoning of Sheppard J. as to the jail term is instructive:

The offences before this Court are serious: in quantum; in the period of time over which they were committed; in the personal (rather than third party) gain achieved and in the systemic consequences for a securities law (at para. 22).

The first reason was based on the fact that the defendant had sold approximately 424,702 shares of Golden Rule for \$4,042,469, a huge amount secured from the investing public, using undisclosed information. The second reason referred to the fact that the trades transpired over a period of time which was dramatically longer than that in Plastic Engine and other insider trading cases. The third reason related to the fact that the defendant had directly profited from his insider trading, an exacerbating circumstance when compared to the Woods case. The learned judge also rejected Young J.'s reasoning in *Her Majesty the Queen v. Plastic Engine Technology Corporation et al.* and stated:

The documentation at trial demonstrated that Mr. Harper was capable of managing Golden Rule and its related companies and still attended several conferences, remote, some of them in foreign locations and still was able to carry on, often in the middle of the night, electronic stock trading in shares of Golden Rule and its related companies. Harper's loss of current employment is the natural consequence of being found guilty of these offences. It is not, therefore, a mitigating circumstance. Also, public disgrace comes with a finding of guilt for such offences [R. v. Harper (2000), at para. 23].

The defendant appealed the convictions and sentence to the Ontario Supreme Court of Justice. Roberts J. dismissed the appeal against conviction and agreed with Sheppard J. that the defendant should get a jail term for the insider trading offence [R. v.

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<sup>72</sup> Section 122(4) states: "Despite subsection (1) and in addition to any imprisonment imposed under subsection (1), a person or company that is convicted of contravening subsection 76(1), (2) or (3) is liable to a fine of not less than the profit made or loss avoided by the person or company by reason of the contravention and not more than the greater of (a) \$1,000,000; and (b) an amount equal to triple the profit made or loss avoided by the person or company by reason of the contravention."

Harper (2002)]. However, he also considered the questions of rehabilitation and made a concession by accepting the presence of mitigating factors. He stated in his judgment:

I am in agreement with the learned trial judge that 'general deterrence requires a form of imprisonment' in this case. I also agree with him that the paramount consideration in sentencing in this case is general deterrence. The questions of rehabilitation must, however, also be considered as must the mitigating factors such as the previous good conduct of Mr. Harper and the extensive character evidence filed on the sentencing hearing on his behalf. I find that the imposition of a one-year sentence constitutes a sentence outside the acceptable range of sentences which should be applied to Mr. Harper on the facts of this case (at para. 29).

Roberts J., therefore, allowed the appeal of sentence by the defendant and reduced the one-year sentence to six months. He also reduced the fine of \$3,951,672 to \$2,000,000, because he refused to conclude that profits made or loss avoided by Mr. Harper were "by reason of the contravention." It must be noted that Roberts J.'s justification for reducing the trial judge's sentence is not so apparent. It can be argued that the sort of people who commit these types of white-collar offences are not those who can be rehabilitated. White-collar offenders are not people who are perpetuating these offences out of personal emotional difficulties such as what we see in the family or youth area. They are violating law out of a sense of greed. For that reason, Roberts J.'s point as to rehabilitation clearly does not stand. On appeal (*R. v. Harper* [2003]), the Ontario Court of Appeal granted the Crown leave to appeal based on its interpretation of the specific fine provisions governing insider trading offences under the *Securities Act*. However, the Court of Appeal dismissed the Crown's request to restore the original fine imposed by the trial judge on the basis that the trial judge had erred in including trading accounts beneficially owned by Mr. Harper's wife and children in the application of the specific fine provisions. The Court of Appeal affirmed the \$2 million fine imposed by the

summary conviction court judge, in addition to a \$400,000 victim fine surcharge (at para. 45-47).

The *Woods* case might have been the start of an exciting development of a more effective enforcement against insider trading in Canada, but, sadly, it seems too early to draw such a conclusion. It can be argued that sufficient and meaningful punishment should be imposed on offenders. A Vice-Chair of the BCSC observed that, besides administrative penalties, there should be jail terms to deter possible insider trading offences. Her statement was quite instructive:

And there should be a prosecution, because in my view, one of the things that is most meaningful to white-collar criminals is that they don't want to go to jail. It's definitely very much a deterrent. Often people on the street, who steal and take drugs and stuff, they don't think about jail - it doesn't matter to them. But often, white-collar criminals are very much concerned about their reputation, their standing in the community, and the fact that they'd be in jail. So out of all the places ... where jail is an effective deterrent, in my view, white-collar crime ... white-collar criminals should be ... jail is an effective deterrent. And so sometimes it's very appropriate - in some cases, administrative penalties are not enough. But they work well hand in hand - it has to be a complementary process to be effective. Because you don't want them trading anymore, so you have to take them out of the market. You have to take away their trading rights, you have to prohibit them from being involved in public companies again. But, sometimes they need a bigger stick ... so, both (Interview with a BCSC Vice-Chair, July 2002).

### ***Conclusion***

Current insider trading regulations are not sufficient to curb insider trading in Canada. The provincial securities commissions and the Crown prosecutors are both reluctant to take up insider trading cases, partly because the cases are too complex. Criminal guilt may be costly and difficult to establish in Canadian courts, where judges are often forgiving towards white-collar criminals. The provincial commissions have limited resources, which restricts the number of insider trading cases that can be pursued.

A negotiated plea or a settlement for administrative remedies is the most common response to insider trading offences.

This chapter has also examined the criminal and administrative sanctions imposed upon insider trading offenders. I have shown that the sanctions are too light to deter illegal insider trading behaviours. Some argue that white-collar criminals actually lose a great deal, because they suffer from the damage done to their reputation and loss of job, after their cases have been exposed to public. Clinard and Yeager (1980: 297), however, observed that the company executives who are fired from office tend to reappear in office as “consultants,” sometimes within the span of only a few days. This study confirms their findings. Several of the sanctioned offenders were promoted to higher positions and achieved even more success. The next chapter looks at the enforcement of insider trading in China.

## **CHAPTER SIX: INSIDER TRADING CASES IN CHINA**

Unlike the Canadian provincial securities commission, the Chinese Securities Regulatory Commission (CSRC) is a national ministerial agency. The bureaucrats in the party government have more direct influence on the enforcement of securities regulations, because it is a less democratic country and the authorities have greater power. The biggest problem in Chinese securities market is price manipulation and insider trading. Players bid up securities prices by spreading false, favourable information about the issuer. They then dump the securities to make profits.

As discussed in Chapter Four, China has criminalized insider trading via legislation which is more severe than in Canada. But the enforcement of laws has done little to eradicate what has become an entrenched feature of the Chinese securities market. Although few insider trading cases have been exposed in China, insider trading continues to prevail. Wu Zhipan, a leading law professor with Beijing University, has observed:

The Chinese securities market has developed for more than nine years. So far, however, the Chinese Securities Regulatory Commission has brought forward only a few insider trading cases. No insider trading case has been dealt with by the courts ... However, the conclusion drawn from this statistics is undoubtedly wrong. Insider trading, manipulation, and other types of fraud are widespread (Interview with Professor Wu, December 2001).

The prestigious Chinese economist Wu Jinglian even compared the market unfavourably to a casino. He has stated:



... More hazardously, prevalent fraud and illegal trading have kept investors from harvesting returns. Today's stock market has turned into a paradise for profiteers. As announced by some foreigners, China's stock market exists as a casino that has yet to be regulated. Even a casino has its rules. For example, you're not allowed to steal a glimpse of another person's cards. In our stock market, however, there are so many underhanded dealings, such as stealing a glimpse at other's cards, cheating and swindling. For a while, some people's wrongdoings, including insider trading, stock manipulation, speculating, and rigging the market, have run wild (No Author 2001: 10).

This chapter is an analysis of insider trading enforcement in China. It describes the function of the CSRC, sources of insider trading cases, investigations, administrative proceedings and criminal proceedings. In the course of the discussion, attention is directed to the nature of various enforcement matters and challenges facing the Chinese securities regulatory agency.

### ***The Power of the CSRC and Its Attitudes Towards Insider Trading***

In 1993, the *PROSIT* provided that the State Council Securities Commission (SCSC) was the government authority responsible for exercising centralized securities market regulations, with the CSRC as its executive body (Art.5, *PROSIT*). Since then, the CSRC has theoretically become the primary regulatory force, comparable to the SEC in the United States, performing almost all supervisory, regulatory, and enforcement functions, under the general guidance of the SCSC, which has overall responsibility for administering the national securities markets.

However, the actual power and capability of the CSRC were rather limited at the beginning, because the traditional financial authorities in China, including the PBOC, made every effort to interfere with the regulation of securities. As Vice-Chair Gao Xiqing (1999: 1) stated:

Without necessary powers to fulfil its regulatory duties, CSRC's enforcement capability was very much limited. The market was described by many as a 'gambling place' characterized by unsophisticated, short-term speculators and the manipulation of institutions. Little was there for long-term market growth and confidence of investors at home and abroad.

The scope of CSRC authority has gradually expanded with the growth of the securities markets. By 1995, the CSRC, through Chairman Liu's efforts and much foreign assistance, had become what some considered China's most highly developed regulatory agency. The significant administrative prosecution of the state-owned Xiangfan Trust and Investment Co. in 1994 brought the CSRC a positive reputation among public investors (Sender 1994: 66). Although there were still very few insider trading cases being dealt with by the CSRC, its regulatory zeal began to influence the behaviours of listed companies. In November 1994, for example, Guangzhou Shipyard filed information with the Stock Exchange of Hong Kong indicating that several executives of the company had violated Chinese insider trading laws. Shanghai Forever Bicycle fired a managing director after he helped friends buy shares in the company before the initial public order (1994: 68).

In March 1995, the CSRC became a deputy-ministerial rank agency which is directly responsible to the Prime Minister. But in response to a series of securities trading scandals, the government appointed Zhou Daojiong as the new chairman of the CSRC. Zhou was a well-known bank leader and held a series of important positions in Chinese financial circles. He had been very scrupulous in financial and securities matters. He stated that "our country's securities market is still at its initial stage with some congenital deficiencies and non-standard performances, such as an imperfect legal system, lack of

powerful supervision and management.” He also remarked on the “imperfect legal system” that still prevailed in China (Zheng 1996: 100).

Responding to Chairman Zhou’s exhortation that “we must see to it that all laws are observed, that law-breakers are dealt with, and that laws are strictly, justly and impartially enforced” (CSRC 1998: 1), the CSRC began to flex its regulatory muscle. In August 1997, the CSRC took over supervision of the Shanghai and Shenzhen stock exchanges. Meanwhile, The CSRC Commissioners’ Offices were set up in the two municipalities. The CSRC achieved at least partial success in its attempts to penetrate the secrecy inherent in securities offences. The CSRC began to institute investigations on their own, without waiting for instructions from the Standing Committee of the State Council (Sender 1996: 7).<sup>73</sup> In 1996, for example, 59 corporations and organizations and 41 individuals received administrative sanctions of reprimands, fines, confiscation, or curtailment of their issuance or trading approval. The total amount of fines added up to 19.7 million RMB yuan. The total amount of confiscation reached 13.3 million RMB yuan. In addition, there were more than 150 removals or discharges of directors, chairpersons, and presidents of 75 publicly traded companies following charges of corruption and incompetence (CSRC 2000: 3).

However, insider trading was overlooked by the CSRC during the period when Zhou Daojiong chaired the Commission. Critics blamed the ineffectiveness of the CSRC in controlling the widespread trend of illegal insider trading and market manipulation.

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<sup>73</sup> The State Council is the cabinet which oversees China’s vast government machine. It sits at the top of a complex bureaucracy of commissions and ministries and is responsible for ensuring that Party government policy gets implemented from the national to the local levels. It is also responsible for law and order. The full Council meets once a month, but the more influential Standing Committee comes together more often, often twice a week. This committee is made up of the country’s premier, four vice-premiers, state councillors and the secretary-general.

Scandal surrounded the Commission, too. After many Western-trained staff left the CSRC in the 1996 and 1997, the latter devolved into a body that used its powers to impose “seemingly arbitrary administrative demands on a cowed securities community” (Dowdle 2000, as cited in Cheng, June 6, 2000). Many scholars blamed the widespread corruption on the chaotic regulatory system and the competition for regulatory influence between the CSRC, the People’s Bank, the State Planning Commission and local governments.

In April 1998, as part of the government’s effort to streamline the bureaucracy, the SCSC and the CSRC were merged to create clearly delimited authority and unified responsibility. Zhou Zhengqing, Chairman of the SCSC, was appointed as Chairman of the new CSRC. The new CSRC, which now enjoys ministerial rank, is the sole securities regulator, overseeing securities brokerages and local securities supervisory bodies, and undertaking the duties of the SCSC (CSRC 1999). In November 1998, all the local securities markets were put under the direct supervision of the CSRC Commissioners. This movement ended a period in which the markets and brokerage and investment houses were regulated by several different government entities at the same time.

The new CSRC drafts the relevant laws and issues rules and regulations for the securities markets, regulates all securities activities, and investigates and exercises administrative sanctions against violations of securities and futures laws and regulations. However, like the British Columbia Securities Commission, the CSRC remains unable to lay criminal charges against offenders accused of insider trading and other types of wrongdoing. The CSRC must refer suspicions of criminal activity to the police and/or the

People's Procuratorates<sup>74</sup> for further investigation. Criminal charges can be laid only by the People's Procurators.

In the single year of 1998, over 100 cases of wrongdoings were investigated by the CSRC with 56 cases concluded and administrative sanctions imposed and three suspects transferred to judicial authorities for criminal prosecution. This was more than the total number of cases handled by the CSRC in the previous three years. These cases mostly involved various malpractices such as market manipulation, false statements, fraudulent conducts, insider trading and illegal IPO and overseas futures transactions. The treatment of serious cases such as the "Qiong Minyuan" false statement and fraud, "Hong Guang" false statement and the "9703 Polywood Contract" price manipulation have won extensive public acclaim and served to build up investors' confidence (No Author 2000). Surprisingly, however, the CSRC finally dropped insider trading charges in all these cases.

The enactment of the PRC *Securities Law* (1998) has erected particularly strong legislative support for the CSRC in the discharge of its enforcement functions, giving the CSRC the power to investigate, to impose administrative sanctions, and to transfer cases to judicial authorities for prosecution. At the end of 1999, the CSRC was fortified by the National People's Congress, which toughened laws to counter insider trading, market manipulation and other crimes in stock and futures exchanges by amending the *Criminal Law*.

In spite of the strong legislative support, China's securities markets are still regularly rocked by allegations of systematic insider trading and market manipulation. It

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<sup>74</sup> A People's Procuratorate is similar to a Crown prosecutor's office in Canada.

was amid growing demands for improving securities industry regulation that Zhou Xiaochuan, a trusted follower of former Prime Minister Zhu Rongji and the son of a minister who was deemed a patron of former President Jiang Zemin, was appointed CSRC chairman in early 2000 (Lam 2001: 1). Zhou has considerable experience in the banking sector, most recently as the reform-minded president of the China Construction Bank (CCB), which has been central to the government's efforts to economic growth through massive spending on infrastructure construction. Central leaders initiated a major redeployment of financial expertise in February of that year, hoping to speed up the development of the financial sector to boost its efficiency and competitiveness, improve its management standards, lower financial risks and strengthen institutional leadership in preparation for China's accession to the World Trade Organization. Zhou's transfer reflected the government's wish to strengthen the regulatory power of the CSRC, which had been criticized for ineffective market regulation and widespread insider trading (Cheng, 2001, January 4).

In 2000, the CSRC carried out a series of administrative reorganizations and major appointments to enhance its enforcement. By the end of that year, the CSRC had set up investigation bureaus in its headquarter and its regional branches. An investigation bureau, which comprises at least one third of branch personnel, is in charge of the enforcement of securities laws and regulations. The investigation bureaus have cooperated with the Securities Exchanges to strengthen real-time monitoring of securities transactions and deal with securities illegalities (CSRC 2001).

In 2001, the State Council appointed a Deputy Minister of Public Security as a CSRC Vice-Chair in charge of investigation and enforcement. In the meantime, the

Commission was granted more power, which was no longer confined to the usual tasks of reviewing trading accounts and transaction records. The new policy allowed the investigation bureau to request the court to seal and freeze bank accounts (CSRC 2002).

Symbolically, many experts in the securities regulation were also appointed to key positions in supervision and enforcement. They included Laura Cha, a U.S.-trained lawyer and the respected former Vice-Chair of the Hong Kong Securities Commission, who was appointed CSRC Vice-Chair in February 2001. It is worth noting that Cha is the first non-mainlander to be appointed to a vice-ministerial position. It is understandable that, to assure domestic and foreign investors' confidence in the regulator, the CSRC approached a number of experienced professionals in the mainland, Hong Kong and overseas to help bring the Chinese securities regulation into line with "global standards."

With the increasing symbolic efforts, the CSRC did pursue some high profile cases of market manipulations by brokerages and fund managers as well as illegal use of bank funds. Between July 1, 1999, when the *Securities Law* came into effect, and November 2000, the CSRC launched investigations into 236 cases of stock and futures trading. As a result of the investigations, the CSRC issued administrative penalties in 100 cases and punished 88 institutions and 142 individuals, with total fines of 466 million yuan. By late 1999, criminal charges or disciplinary action had been taken against 39 officials for deception, faking figures, bribery, and other illegal dealing. Among the ten officials who lost their jobs and faced criminal charges were the city's deputy party secretary, the former chairman of the local people's congress, and the deputy director of the taxation bureau (CSRC 2000).

However, insider trading was obviously not the CSRC's enforcement priority, although regulatory officials blamed the prevalence of insider trading in many public occasions. Like government regulators in other countries, most Chinese regulatory officials also attributed the lack of insider trading cases to inadequate human and financial resources. One senior official, however, explained that lack of power to investigate discovered insider trading cases was a more challenging problem:

Actually, we did discover a large number of cases through our detection efforts. But the party disciplinary committees wanted to deal with them through the party and government's internal disciplinary measures, because they didn't want those cases to dilute the reputation of China, the stability of Chinese capital markets ... You know, we are not like in Canada, we have to consult with the provincial or municipal party branch to pursue those cases ... not only the CSRC, but the procuratorates, courts, all have to report major cases to the party before they take action. This is the situation in China, as you know (Interview with a CSRC senior official, December 2001).

### ***Sources of CSRC Insider Trading Cases***

There are primarily three means by which the CSRC detects or becomes aware of insider trading activities. First, commission staff who are on the front lines of enforcement proactively search for illegal behaviour through regular inspections or by scanning the financial news for clues. Commencing in 2001, each staff member has been required to inspect at least five listed companies per year, and to inspect all listed companies in the region for which he or she is responsible on a triennial basis. This new measure was initiated by the new Vice-Chair Laura Cha and has resulted in increasing quantities of insider trading case clues. If the inspector decides that sanctions are necessary, the case report, complete with preliminary evidence, will go through many levels of review before being submitted to the chairman for approval of a formal investigation (Interview with Professor Gu, December 2001).



Since public scrutiny is an important element in the Western system of checks and balances, the impetus to conform to WTO rules and the popular distaste for corruption appears to be pushing the Chinese system into accepting more public scrutiny. Therefore, investigators may now obtain clues from news stories which reveal the names of insiders who are suspected of illegal insider trading. They may then pursue this line of inquiry to determine whether such stories are true. The *CaiJing Magazine*, one of the most respected financial titles in the mainland, is a major source which reveals insider trading and market manipulation in China's stock market. The insider trading stories in *CaiJing* triggered the investigation of certain companies and brokerage houses by the regulatory authority. It was through a news report in *CaiJing* that the Yinguangxia (Tianjin) case came to the attention of the CSRC. The CSRC was acknowledged by the media for its quick action in this case. The Director of the CSRC Enforcement Bureau stated in the interview:

I remember it was August 3, Friday. After I read the news report in the Finance and Economy Magazine, I immediately met with a deputy director in charge of securities trading illegalities and a principal investigator. We decided to organize a special investigation team and go to Tianjin on Saturday. We formally began the investigation on Sunday. Within nine days we found initial evidence that one of the company's wholly owned subsidiaries had made false financial statements and been involved in illegal insider trading (Interview with the Director of the CSRC Enforcement Bureau, December 2002).

Another example involves Guangxia (Yinchuan) Industry Co., a Shenzhen-listed biochemical firm, whose stock rose 440% over the course of 2000, made it the second-best performing company in the Chinese securities market that year. In mid-2001, the media reported that a Guangxia subsidiary had released false data in order to manipulate

the firm's stock price and conduct insider trading. The CSRC immediately launched an investigation that confirmed the magazine's findings.

The second way the CSRC becomes aware of insider trading is through the Civil Complaint Office of the State Council, which deals with various kinds of complaints in the country. When this office receives clues about possibly significant securities offences, it will report to the Superintendent's Office of the State Council, which will then order the CSRC chairman to deal with them. In such a case, the CSRC enforcement staff immediately commence an investigation and, under normal circumstances, finalize it within three months. If the staff cannot complete the case within the stipulated time, they report the reasons of delay and a new schedule to the Superintendent's Office (CSRC 2000).

In the third method of detection, the CSRC receive cases from complainants and informants. Inside informants may report unusual or suspicious trading to the CSRC by telephone, mail, email or in person. The CSRC Enforcement Director stated in an interview with the *CaiJing* Magazine:

The enforcement staff will investigate all such cases and report the results to the ominous complainant or informant. We will notify the informant the result in the case of signed information. About two thirds of insider trading cases have come from informants' tips, which in most cases are found reliable (Xiao 2001: 15).

In May 28, 1998, the CSRC initiated the CSRC Chairman's Hot Line and Chairman's Mailbox, which are open to public complaints and comments. Within one month of this service being opened, the CSRC had received 2,973 calls and letters, 38 percent of which provided tips of illegalities including insider trading violations.

The CSRC promises bounties and compensation for loss to non-culpable insider informants. The CSRC Enforcement Director described this policy as “very useful” to induce insider trading information (Interview with the Director of the CSRC Enforcement Bureau, December 2001). Sometimes when an insider participating in insider trading is dissatisfied with his or her loot share with other participants, he or she may also reveal the case to the CSRC if the latter promises more lenient penalties. It was through the letter of a disaffected senior executive that insider trading and other offences in the company that the *Tonghai High-Tech Company* case came to light.

For outsiders, economic incentives may be effective in inducing information about insider trading offences. To encourage people to inform the CSRC of actual or potential illegalities, the CSRC provides a bounty of no more than 20,000 RMB yuan for informants whose tips are proved true. At the discretion of the CSRC, an informant who reports key information about a major case may be awarded a bigger bounty up to one per cent of the profits made in the case. However, as Wan (2002: 45) stated, although the Commission promises confidentiality, complainants and informants may not be induced by bounties because they may worry about possible revenge by offenders. In the absence of empirical data, it is not clear how great an inducement this would be to bring people forward with information.

Finally, there are referrals of investigations conducted by the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The stock exchanges have the responsibility of monitoring the day-to-day trading activities on their respective exchanges for violations. The CSRC, on the other hand, maintains oversight of these exchanges. According to the rules of the stock exchanges, senior executives of listed

firms have to report changes concerning stocks they hold, and are not permitted to trade on inside information. These people are only allowed to buy and sell shares of their company six months after they have left the company. Shanghai Stock Exchange reported to the CSRC in July 1999 that four cases of illegalities including insider trading had been discovered during a survey of over 600 top executives of 54 listed companies.

The CSRC and the two stock exchanges in China have recently imported sophisticated computer surveillance software systems from the United States to track insider trading. The CSRC and the exchanges will use software that continually flags unusual price and volume swings in the 10 days before and after major news events such as takeovers, based on the historical patterns of the individual stocks. Information generated by the program is then used to build a chronology of events, and a case. While we know that the SEC's success in tracking cases of fraud, including insider trading, has been greatly complemented by the electronic data gathering, analysis and retrieval system that performs automated collection, validation, indexing, acceptance and forwarding of the various submissions which the companies listed in the US are required to file with the SEC, it is still too early to precisely evaluate the effectiveness of this computerized surveillance system in detecting insider trading offences in China at this stage.

### ***CSRC Investigations***

The *Securities Law* of China authorizes the CSRC to conduct investigations to determine whether the behaviour in question has violated the law. Similar to those by the Canadian provincial securities commissions, CSRC investigations are also private in most cases. Not surprisingly, the conduct of CSRC enforcement is even less transparent. Unlike Canadian commissions, the CSRC does not issue annual reports available to the

general public. Its regular news report, leaders' speeches and other publications reveal little about the organization of its work. The description of investigative work by the CSRC is derived from the limited CSRC publications, my interviews with present and former CSRC personnel and a few newspaper interviews.

Investigations are conducted by the Enforcement Bureau in the CSRC headquarters in Beijing as well as by eleven regional offices located in Beijing, Shanghai, Tianjing, Chongqing, Shenzhen, Guangzhou, Wuhan, Chengdu, Xi'an, Jinan and Shenyang. When the CSRC was established in 1993, there was no Enforcement Bureau or other enforcement offices. In 1996, the Complaints Division of CSRC Legal Affairs Department with only four staff was reorganized into the Enforcement Bureau. There are at present altogether 33 enforcement staff in the headquarter Enforcement Bureau and 256 in regional offices, with 15 percent of whom handle insider trading and market manipulation cases (CSRC 1999).

After an insider trading case is initiated, the Enforcement Bureau or its regional offices will investigate the possible existence of an insider trading violation. The regional offices form the front line of enforcement work. The primary responsibility for investigation rests with the Commission's regional administrators whose investigators conduct most of the investigation work. Investigations conducted by the regional offices are supervised and coordinated by the Enforcement Bureau and the Coordination Office for Regional Offices in the CSRC headquarters. These two headquarters' offices track regional office cases and assign or redeploy personnel to assist in substantial regional office investigations. The headquarters Enforcement Bureau would initiate its own investigation where cases are extremely important (for example, those assigned by the

State Council), or where the Bureau is not satisfied with the investigative results (CSRC 1999; 2000).

The CSRC investigators are predominantly attorneys. Most of them have come from courts, prosecution offices and law firms and do not have much experience and knowledge in the securities field. Although the CSRC, with the assistance of universities, launched several training programs, most enforcement staff members are immersed in their heavy workload and therefore find little time participating in these training opportunities (Interview with the chief CSRC enforcement officer in Shanghai Branch, December 2002). The lack of professional knowledge and experience has become the major disadvantage of investigators in proving insider trading illegalities. In order to improve the effectiveness of investigations, the CSRC was given the authority in 1996 to borrow expert personnel from accountant companies and securities law firms to organize investigation teams to assist investigations.

During the investigation, the CSRC investigators have been conferred the power to adopt the following measures: 1) to enter the site where an illegal act is committed to investigate and collect evidence; 2) to question the party concerned and any unit or individual connected with the event under investigation, and to require them to give explanations concerning matters connected with the event under investigation; 3) to inspect and make copies of the securities trading records, records of registration of change in ownership, financial and accounting information and other relevant documents and materials of the party concerned and any unit or individual connected with the event under investigation, and to seal up documents or materials likely to be removed or concealed; and 4) to examine the fund accounts and securities accounts of the party

concerned and any unit or individual connected with the event under investigation, and if there is evidence to substantiate signs that illegally obtained funds or securities have been removed or concealed, to apply to a court to freeze them (CSRC 2001).

The CSRC itself, however, has no power to examine bank accounts, company registration with the Administration for Industry and Commerce and tax records, no power to freeze fund accounts and securities accounts, and no power to issue a subpoena for the production of documents and the appearance of witnesses and to take sworn testimony. Many asset management corporations (AMCs),<sup>75</sup> which are a major site for insider trading illegalities through asset restructuring, would often refuse to cooperate with the CSRC in its investigations (CSRC 2000).

There were only seven insider trading cases known to the public since the *In re Xiangfan* case. It was not because of the CSRC's ability to curb insider trading. Anyone who has any basic knowledge of the Chinese securities market would not believe these were the only cases. In fact, so many people engage in it all the time because so many

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<sup>75</sup> China initially had four financial asset management companies (AMCs), each paired with one of the main commercial banks: Cinda with the Construction Bank of China, Great Wall with the Agricultural Bank of China, Oriental with the Bank of China and Huarong with the Industrial and Commercial Bank of China. In addition to this a further six licenses have been issued to other companies allowing them to be involved in asset management. All AMCs remain under the supervision of People's Bank of China with input from the State Securities Supervisory Committee of China and the Ministry of Finance. In many ways China's AMCs are an arm of the state. Currently their major activity is debt-equity swaps, which are selected by the State Economic and Trade Commission (SETC) and not the AMCs themselves. In this way the AMCs are a crucial part of the government's overall restructuring program for the state-owned sector in China. Over the long term the AMC's are aiming to recover approximately RMB 1 trillion in non-performing loans owed to the country's four major state-run commercial banks by China's loss-making state-owned enterprises. This is a major task for the AMCs given that China's state owned industries are estimated to face US \$200 billion in bad debts. The longer-term aim of the AMCs is to rehabilitate the loss making large state-owned companies and eventually liquidate their stakes by selling or listing the shares of the firms. However, whether the AMCs will be able to revive the firms and find a market for their shares remains to be seen.

other people are doing the same thing. As long as you are not “too greedy,” the CSRC will not even notice you.

In commenting on the difficulties of investigations, the chief CSRC enforcement officer in the Shanghai Branch told the author in the interview:

We don't have sufficient power and resources to investigate. For example, we cannot enter a company to search for evidence. We cannot obtain through subpoena any evidence relevant to determining whether a violation of the securities laws has occurred. When we apply for a search warrant courts are normally reluctant to issue the warrant for us. This has increased difficulties for investigators to obtain evidence for insider trading offences. During the investigation of Chinese Science Group's insider trading, for example, some major offenders had fled long before a search warrant was issued (Interview, December 2001).

In 2001, the CSRC started working with the Public Security Ministry to create a special unit to investigate insider trading and other stock market crimes. During the investigation period, the Enforcement Bureau or its regional offices may give preliminary determinations, resulting in either provisional remedies or cancellation of investigations.

### ***Administrative Proceedings***

The Hearing Branch of CSRC Enforcement Bureau is responsible for conducting initial hearings and making preliminary decisions under the *Securities Law*. Like investigators, most hearing officials are also young attorneys. Some of them were former public prosecutors or attorneys. The Hearing Branch's decisions must be approved by regional administrators and the CSRC chairperson before they are finally reported in internal monthly bulletins (CSRC 2000).

In most instances, an administrative sanction can be imposed only after a hearing before a hearing official. A hearing official presides at a hearing between the CSRC



enforcement staff and the respondent. A Hearing Department panel is organized to decide a major administrative sanction on a complicated case or a major violation of the law. At hearings, investigators present the facts and evidence of violations of the insider trading law by the respondent, without calling witnesses, and suggest administrative sanctions. However, CSRC enforcement staff do not always appear at the hearing. They simply submit written documents to the hearing official. The hearing official or panel read the accusation at the hearing to the respondent, who has the right to make a statement and to defend him or herself. The hearing official or panel must fully hear the defence of the respondent and shall verify the facts, reasons and evidence presented by both the CSRC enforcement staff and the suspect. The hearing official or panel shall make findings of fact and conclusions of law (CSRC 2000). According to the *Administrative Procedure Law of China*, the administrative body (here the CSRC) must establish by a preponderance of the evidence that the respondent has engaged in insider trading illegalities.

Unlike the securities regulators in Canada, the CSRC hearings are usually not open to the public or media. It should be noted that, according to the *Administrative Procedure Law of China*, the respondent has the right to a public hearing. With the exception of cases involving state secrets, business secrets or individual privacy, hearings shall be held in public. It is unclear what kind of information related to the stock market should be regarded as “state secrets or business secrets” that cannot be known by the general public. Secrecy is sometimes a badge of the government’s attempts to cover up an insider trading case on the basis of its significant political connections. The government must realize that there is a legitimate public interest at stake involving

matters that the public has a right to know. A CSRC hearing official stated in the interview:

We were often reminded of state secrecy protection in dealing with securities cases, although as you know, insider trading and manipulation of the market by large investment institutions (Zhuang Jia) is a well-known secret in China. That's why I cannot invite you to a hearing of securities cases or release any hearing documents to you (Interview, December 2001).

After the hearing, the hearing official or panel make one of the following decisions according to the merit of each case: 1) A decision to mete out administrative punishment to violations of law liable to administrative punishment, taking account of the seriousness of each case and its specific conditions; 2) A decision not to mete out administrative punishment to slight violations of law that are not liable to administrative punishment; 3) A decision not to apply administrative punishment to a case in which the facts cannot prove a violation of law; 4) A decision to submit a case in which violations of law constitute criminal offences to a judicial department (CSRC 2000).

When the hearing official or panel imposes administrative sanctions, they shall prepare a decision letter for the CSRC enforcement staff and the respondent. The letter shall contain the following: 1) the names and addresses of the parties concerned; 2) the facts and evidence of violation of the law, regulations or rules; 3) the type of administrative punishments to be imposed and the grounds for imposing these punishments; 4) the manner and period of carrying out the administrative punishments; 5) if the parties concerned do not agree with the administrative punishments decision, the channels and deadline for application for administrative reconsideration or for filing an administrative lawsuit; and 6) the name of the CSRC branch that makes the

administrative punishments decision and the date the decision is made (CSRC 1999; 2000).

The administrative punishments decision letter must be stamped with the seal of the CSRC branch that makes the decision. The administrative punishments decision letter shall be handed to the parties concerned on the spot after the decision is announced. If the parties concerned are not present, the administrative agency shall send the letter to the parties concerned within seven days, according to relevant stipulations of the civil procedure law (Interview with the CSRC Vice-Chair and Chief Accountant, December 2001).

As discussed in Chapter Four, sanctions for engaging in insider trading associated with administrative proceedings include a reprimand, an order to return illegally obtained funds, confiscation of illegal income, paying a fine, and more severely, prohibition from issuing stocks or trading on the stock exchange or from directing or being an officer in any publicly traded companies temporary or permanently. Before the new Chinese *Securities Law* was enacted, the CSRC could impose an administrative fine of 50,000 to 500,000 RMB yuan on insider trading violators. According to the new Law, the administrative fine for insider trading has been changed to one to five times the illegal income or an amount not more than the value of the illegally trading securities. The stipulated maximum administrative fine for insider trading is arguably higher than in most other countries.

The first insider trading case that the CSRC dealt with under *PROSIT* and *PMFSFB* was the *In re Xiangfan* case [CSRC (1994) 1] in 1994, which is related to the first acquisition case in China. On September 16, 1993, representatives of Xiangfan Trust

and Investment Co. (Shanghai) learned from a business negotiation with representatives of Shenzhen Huayang Nutriment Co., an affiliated company of Shenzhen Baoan Group, that the latter company was going to acquire Yanzhong Science and Technology Group. Based on this inside information, Xiangfan purchased 627,300 shares of Yanzhong stock during the period between September 17 and September 27, and sold these stocks on the open market on October 7, when the market price of Yanzhong stock increased substantially. The CSRC held Xiangfan liable for insider trading, confiscated 16.7 million RMB yuan of illegal income and 5,300 illegally obtained shares from the insider trading offender Xiangfan, fined it 2 million RMB yuan which was far beyond the stipulated fine limits, stopped its trading approval for two months, and ordered it to conduct internal rectification for the CSRC to check before re-approval (Jiang et al. 2001: 40). This case was important because the Agricultural Bank of China, which owns Xiangfan, is a major state-owned commercial bank. While this decision is welcomed in that the CSRC sent a strong message to deter potential insider trading offenders, the 2 million RMB yuan fine was obviously an arbitrary penalty which was inconsistent with either PROSIT or PMFSFB.<sup>76</sup>

In the years since the *In re Xiangfan* case, surprisingly few cases of insider trading were filed by the CSRC until 1997. However, the CSRC continued to impose arbitrary penalties which were against the law then, probably in order to foster the illusion that it was able to adequately enforce the insider trading law. It might also represent the government's worry about possible riots and therefore attempted to appease the public investors with a severe penalty on a scapegoat offender, even at the expense of

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<sup>76</sup> It is unknown why Xiangfan did not appeal the unjustifiable 2 million RMB yuan fine.

legality. However, the government has overlooked the fact that instability is simply too easily unleashed in society when governments fail to provide fundamental safeguards for individual rights of the public.

In 1997, Zhangjiajie Tourism Development Company was found liable by the CSRC for insider trading offences. Zhangjiajie bought 41,500,000 RMB yuan of its own shares before it announced a bonus issue of shares and made a 11,805,000 RMB yuan profit. The company was forced to disgorge its illegal profits and was fined 2,000,000 RMB yuan. The general manager and deputy general manager of the company were each fined 50,000 RMB yuan and were forced to resign from their positions.

Two high profile insider trading cases decided in 1999 under the new *SLPRC* served as a prelude to the recent media blitz. In the *China Motorcycle Group* case, the Securities Department of China Motorcycle Group bought 5,800,000 Jinan Motorcycle shares, in advance of the annual earnings announcement of Jinan Motorcycle. According to the complaint, China Motorcycle Group was a majority shareholder of Jinan Motorcycle. Zhang Min, Secretary of the Board of Directors and Director of the Securities Department of China Motorcycle Group, was one of a small number of senior officials who had unlimited access to material, non-public information about Jinan Motorcycle.<sup>77</sup> According to the complaint, Zhang Min thus knew information about Jinan

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<sup>77</sup> Zhang Yujun, President and CEO of Shenzhen Stock Exchange criticised the imperfect management structures of the listed companies. Zhang stated that even though each listed company has established an administrative structure which is made up of a shareholders' general meeting, a board of directors, a board of supervisors and the management, in reality, some majority shareholders are always not separated from the listed company in terms of personnel, financial affairs and asset management. In effect, two companies are often operated by the same team. The administrative structure cannot become effective under such a situation. According to a sample survey conducted by a relevant authority, the administrative structures are problematic for as many as 35.5% of listed companies. There is an absence of effective control mechanisms in some listed companies and in many cases the interests of minority shareholders are harmed. These companies are dried up by their majority shareholders and are on the verge of bankruptcy.

Motorcycle's annual financial performance before such information was disclosed to the public. The Securities Department of China Motorcycle Group realized unlawful profits of 25,420,000 RMB yuan through insider trading. The CSRC confiscated the illegal insider trading profits and fined China Motorcycle Group 5,000,000 RMB yuan. Zhang Min was fined 50,000 RMB yuan, forced to resign from any position he might hold as a director or officer of any reporting issuer, and permanently prohibited from becoming or acting as a director or officer of a reporting issuer or a securities broker. Zhang Jialing, President of China Motorcycle Group, was forced to resign any position he might hold as a director or officer of any reporting issuer, and prohibited from becoming or acting as a director or officer of a reporting issuer or a securities broker for a period of three years.

On the heels of the *China Motorcycle Group* case came that of Nanfang Securities and Beida Motor. Nanfang Securities Company is one of the major players within the Chinese securities market.<sup>78</sup> In October 1996, Xiong Shuangwen, Deputy General Manager of Nanfang Securities, obtained insider information from President and General Manager Li Chuanhong and Deputy Manager Wang Wenchao of Beida Motor Company during his visit to Beida, about the company's estimated annual profits, intended bonus issue and investment plans. The two companies secretly made a binding agreement to trade on the inside information. During December 1996 and April 1997, Nanfang Securities Company traded 60.61 percent of floating shares of Beida Motor. Nanfang Securities Company made 74,558,900 RMB yuan in insider trading profits. Beida Motor

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<sup>78</sup> Securities companies developed very quickly during the period of 1991-1996. At that time, People's Bank of China, Ministry of Finance and the Specialized Banks established their own securities departments one after another. In October 1992, in accordance with the boom of China's stock market, the Chinese government established three major securities companies, Huaxia, Guotai, and Nanfang in Beijing, Shanghai, and Shenzhen, respectively. The securities companies that are backed by banks gradually consolidated their dominating role in securities underwriting and other securities businesses.

made 850,000 RMB yuan profits from the illegal trading. The Commission found that “the suspicious trades made by Nanfang Securities Company must have been made on the insider information received from Li Chuanhong and Wang Wenchao that had not been generally disclosed” (CSRC 2000: 16). The CSRC confiscated the illegal insider trading profits made by Nanfang Securities Company and Beida Motor Company, and fined the former 5,000,000 RMB yuan and the latter 1,000,000 RMB yuan. Xiong Shuangwen was reprimanded and fined 50,000 RMB yuan and prohibited from trading securities for a period of six months. Li Chuanhong and Wang Wenchao were reprimanded and ordered to pay a fine of 50,000 RMB yuan each. Wang Jingshi, President of Nanfang Securities Company, and Shen Pei, CEO of the company, were also reprimanded by the CSRC.

Some of the primary factors that have influenced the CSRC decision to impose a more severe administrative penalty on an offender include the seriousness of the offence (in terms of the monetary value involved) and the socioeconomic status of the offender (Interview with the CSRC Vice-Chair and Chief Accountant, December 2001). As discussed above, the government’s worry about small investors’ riots may have had an impact on the perceived seriousness of white-collar crimes, with a resultant increase in administrative penalties for a few major organizations and high status individuals. Generally, organizations are more likely than individual offenders to receive a heavy fine. However, even with the above relatively severe penalty cases that the CSRC has been proud of, the fines imposed were still much less than the profits made. Most individual offenders were merely reprimanded and fined a relatively small sum of money. Fines

imposed on individual insider trading offenders usually ranged from 50,000 to 150,000 RMB yuan.

In the *Wang Chuan* case (1998), Wang, Deputy CEO of Beijing University's Founders Computer Group, acquired material, non-public information concerning the acquisition of Yanzhong. The Commission alleged that, on the basis of that information, Wang purchased shares of Yanzhong prior to the May 11, 1998 public announcement of the acquisition. He realized illegal profits of 610,000 RMB yuan. Wang was ordered to disgorge the illegal profits and was fined 100,000 RMB yuan.

In the *Dai Lihui* case, CEO of Sichuan Top Science and Technology Development Company, traded 3,200,000 RMB yuan of Sichuan Changzheng shares, based on the insider information of intended restructuring transactions between the two companies. Dai made 675,700 RMB yuan in trading profits. The CSRC confiscated his illegal insider trading profits and fined him 150,000 RMB yuan.

Similarly, in the *Yu Mengwen* case (1999), the respondent, a science and technology manager of Panzhihua Iron and Steel Group, traded 205,633 RMB yuan of Panzhihua shares, before the company announced its plan of capital restructuring and share capital increase. Yu earned 80,000 RMB yuan in illegal profits. He was forced to disgorge the illegal profits and fined 50,000 RMB yuan.

A recent case of insider trading is the administrative charge against a director of Tianjin Lida Group, Gao Fashan. He purchased 2,000 shares of Tianjin Guoshang before the announcement of the Board's decision to transfer the company's Tianjin Guoshang shares. He was reprimanded and forced to disgorge the illegal trading profits.



A reprimand, a fine of under 50 RMB yuan in the case of an individual offender, or a fine under 1,000 yuan in the case of a company or organization can be imposed on the spot. When making an on-the-spot decision on administrative sanctions, the hearing official must show his official identification card to the relevant party, fill out a numbered administrative sanction form, and give it to the relevant party on the spot. The administrative sanction form should explicitly contain the details of the relevant party's violation of the law; the basis for the administrative sanction, and the amount, time and location of the fine. The hearing official must sign or seal the completed form and report the decision to the regional administrator and the CSRC chairman for filing purposes. If the relevant party does not agree with the on-the-spot decision on administrative sanctions, he or she may apply for an administrative review by the regional administrator or the CSRC chairman within 15 days (CSRC 2001).

According to the Chinese law, there are two appeal routes available for a person who is dissatisfied with a CSRC decision. First, the aggrieved person can appeal to the State Council for a case review. If the person is again not satisfied with the review, he or she may further appeal to a court of law. Second, the person can directly appeal to a court of law. However, such appeal avenues only exist theoretically, and are very difficult to go through in reality. Article 210 of the *Securities Law* provides:

If a party concerned disagrees with the punishment meted out by a securities regulatory body, or by the department authorized by the State Council, it may follow the legal procedures and request a review of the case. He may also directly file a suit at the people's court according to the law.

However, no further interpretation is provided to specify which department is authorized by the State Council to review CSRC decisions. In practice, the State Council

normally authorizes the CSRC itself to review such appeal cases, which have never been reversed so far. The Chinese courts are traditionally not interested in hearing appeals from CSRC decisions and usually throw these cases back to the CSRC.

### ***Criminal Investigation, Prosecution and Sanctions***

According to the law, the CSRC may refer the case to the police, or the Public Prosecutor's Office in the case of a party or government official, for criminal investigation. Faced with the tendency of increasing cases of securities crimes, in 1998, the Ministry of Public Security of the PRC set up the Department for Economic Crimes Investigation (ECID) to lead and coordinate the fight against economic crimes by public security organs at different levels of the country. At the beginning of this year, the Division of Securities Crime of ECID was stationed in the CSRC to handle official business together with the CSRC Enforcement Bureau. Currently, 30 police investigators are engaged in investigation into securities crimes in the headquarters of the Division of Securities Crime of ECID. Special agencies for investigation of securities crimes were also established by public security organs at various levels to undertake concrete tasks of investigating securities crimes. This professional team of investigation is expected to play a major role in increasing enforcement measures against securities crimes. According to the news, they will possess not only a stronger ability in real time supervision on market waves but also various instruments in detection, including investigation "stool pigeon" – informer surveillance. The Vice-Chair and Chief Accountant of the CSRC showed optimism about the police investigation of securities crimes:

It will become much more powerful in closing down and freezing banking accounts instead of simply resting on "auditing transaction account and record" as we do. The police also have the power to search, seizure, and arrest suspected offenders. I am pretty sure the new Division of Securities

Crime will work well in deterring and curbing insider trading and other securities crimes (Interview, December 2001).

However, Professor Gu cast doubt on the potential effectiveness of the police investigation of securities crimes. He stated in the interview:

The police Division of Securities Crime is still largely symbolic. It's too small and still ill-prepared to deal with the complexities of securities crimes such as insider trading. Most regional police departments don't have even a skilled investigator with expertise in securities. It may do something with its power and resources, but you cannot entertain high hopes (Interview, December 2001).

It is easy to understand Professor Gu's view when we look at the fact that no criminal or civil charges have been filed against insider trading offenders. Neither the People's Procuratorates nor the People's Courts are interested in taking on insider trading cases because they do not believe that insider trading is a serious "crime". Insider trading cases have usually been exposed by People's Procurators only when these cases have had connections with bribery and corruption, the "real" crimes.

In the *Guan Weiguo* case, Guan Weiguo, the Administrator of the CSRC's Shenyang Branch, was prosecuted by Shenyang People's Procuratorate in 1994 for bribery and insider trading. Guan accepted about 55,000 RMB yuan worth of bribes from January to March 1993 from four companies in return for recommending these companies' registration at the CSRC and ensuring a guarantee for these companies to be listed on securities exchange. He was also charged with purchasing 340,000 RMB yuan of Shenyang Fangtian shares based on insider information. He was at a CSRC meeting in Beijing in which Shenyang Fangtian was approved by the CSRC to be listed on the stock exchange. He purchased the stock on his wife's account 340,000 RMB yuan of Shenyang Fangtian shares and sold them after the company was listed on stock exchange, making

around 770,000 RMB yuan in the process. Surprisingly the insider trading charge against him was later overlooked by the judge.<sup>79</sup> Guan was only convicted of bribery and sentenced to six years imprisonment by Shenyang Intermediate People's Court.

The judicial indifference towards insider trading was also reflected in courts' discouraging attitudes towards civil litigation for insider trading. On September 24, 2001, the Supreme People's Court issued a notice that "cases involving civil compensation due to insider trading, fraudulence and market manipulation on the securities market should not be accepted for the time being." However, according to the law,<sup>80</sup> insider trading cases definitely meet the conditions for taking action and the court has no reason to refuse to accept them.

The Supreme People's Court explains that the court currently lacks the resources for trying such cases. A senior judge of the Supreme People's Court stated:

There are two reasons for not accepting such cases at the moment. One is related to legislation. The *Securities Law* provides very abstract stipulations on civil liabilities. As the stipulations are not specific enough, the courts have difficulties applying them. The other is related to the administration of justice. Judicial personnel have unsatisfactory quality, and relevant judicial interpretations are yet to be unveiled. We recognize that, according to the law, the court should accept these cases. However, as cases involving securities disputes are complicated with wide connections and big influence, it is better not to accept such cases for the time being, considering both the legal and social effects of a trial (Interview, December 2001).

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<sup>79</sup> In China, judges are not required to write out the reasoning behind their rulings where they emphasize the enumeration of accusations. This practice has encouraged judicial arbitrariness, misjustice and even corruption. See Yin Lei (2002: 2).

<sup>80</sup> Article 108 of the Civil Procedure Law of the People's Republic of China stipulates four conditions for bringing a lawsuit: 1) The plaintiff must be a citizen, legal person or organization that has a direct interest in the case; 2) There must be a definite defendant; 3) There must be a specific claim or claims, facts, and a cause or causes for the suit; 4) The suit must be within the scope of acceptance for civil actions by the people's courts and under the jurisdiction of the people's court where the suit is entertained.

In early August 2002, Guangxia Industry, a listed company known for its outstanding performance, was exposed by the media for disclosing phony information and insider trading. In two years, Guangxia created dazzling records in terms of both stock price and performance. In the year 2000, its stock price rose 440 percent, ranking first on both the Shanghai and Shenzhen stock exchanges. Its capitalization exceeded 10 billion RMB yuan. However, everything concerning the company was false. Guangxia made up export contracts, fabricated the list of exports, boosted performance, created false annual reports and disclosed phony information. The company traded its own shares on the false information, well before other investors discovered the company's hoax. In early August, the company was suspended from trading for one month. When trading resumed, stock prices plummeted for 15 consecutive down limits<sup>81</sup> from more than 30 RMB yuan to about 5 RMB yuan, setting a record on the Chinese stock market. According to the mid-year report, by the end of June, Guangxia had a total of 14,245 shareholders.

The CSRC initiated an extensive probe of the company, and the Ministry of Finance eventually stripped the accounting license of the company's longstanding auditor, leading observers to nickname Guangxia the "Chinese Enron." The CSRC recently referred the case to the People's Procurators for prosecution. Meanwhile, more than 100 investors brought a suit against Guangxia Industry at local courts in Shanghai and Wuxi, which was nevertheless rejected by the courts under the Supreme People's Court's notice. The attorney for the plaintiff said bluntly that the current regulatory system could not provide enough protection to public investors.

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<sup>81</sup> Maximum price drop allowed on a stock in a single trading day.

## ***Conclusion***

Although the Chinese government has made an effort to tighten insider trading regulations, the prevalence of insider trading cases has grown. There are some major problems with Chinese insider trading regulations. There is no effective regulator. In China, the problem exists not simply with respect to difficulties in finding insider trading offenders. The biggest problem is that party bureaucrats will decide whether or not to punish an offender, based on their own political interests. The laws are in the books, but there is no “watch dog.”

In marathon press interviews, Zhou Xiaochuan has reiterated the CSRC’s determination to investigate and punish insider trading and other forms of manipulation. “We will promote the principle of corporate governance in line with China’s actual conditions,” Zhou said, adding that the market definitely was not a bubble (Lam 2001: 1). Zhou said that many laws and regulations were in the pipeline on areas including accounting and auditing practices, disclosure requirements and shareholder rights.

Under Zhou’s leadership of the CSRC, 2001 may very well be remembered as the year of improving enforcement of securities laws. While emphasizing investor education, the CSRC has steadily toughened enforcement measures vis-à-vis listed firms and securities firms. In early April 2001, for instance, the CSRC issued regulations on the methods for inspecting listed companies, which replaced an earlier set of rules issued in 1996. The *Methods for Inspecting Listed Companies* includes provisions on the use of funds raised for earmarked purposes, investor complaints, as well as problems revealed by the media in major reorganizations.

In April, in a watershed for China's listed firms, PT Narcissus, a Shanghai-based firm that came to the market in 1992, became the first delisted firm after having run up hefty losses for four consecutive years. In fighting the so-called zhuangjia (arch manipulators) that specialize in driving up the prices of certain stocks before getting out and leaving small investors holding the bag, the CSRC acted slowly so that the manipulators had largely left by the time trading was halted in the case of Yi'an Keji (Yorkpoint Science & Technology Co.). By summer 2001, the CSRC had become far more decisive and effective. In July-August it was able to freeze these manipulators in the cold in the case of Guangxia (Yinchuan) Industry Co. for falsifying earnings figures at its Tianjin branch.

However, the movement against insider trading did not actually come with the stricter enforcement of other offences such as market manipulation, although the CSRC always presented insider trading as a severe problem worthy of harsh crackdown. During the year of 2001, which is called "enforcement year" by the CSRC, no insider trading cases were found among the illegalities with which the CSRC dealt. A primary challenge in the insider trading regulations comes from the fact that most insider trading cases involve high-ranking government and party officials (Shenzhen Municipal People's Procuratorate 1998: 37). The CSRC needs more power, more resources and more trained regulators to detect and address insider trading activities. In addition, since the party government is still the largest investor, this kind of public-private overlap increases the ability of government officials to trade on inside information related to political events (Gurdon 1993: 12). However, the CSRC lacks the power to directly administer discipline on government officials and party cadres for insider trading offences.

## **CHAPTER SEVEN: CONCLUSION**

Insider trading has been a prominent issue recently in both Canadian and Chinese contexts, although it may take different forms. This dissertation has analysed insider trading laws and enforcement in the two countries, showing the similarities and differences between the two nations in their development and application of insider trading laws. The findings presented in this study tend to show that only a small number of insider trading offenders have been charged administratively or criminally in both countries. Theoretically, the nature of insider trading legislation determines in part how securities commissions become aware of breaches of insider trading laws and how they respond to those breaches. The major conclusion of the dissertation, however, is the importance of other factors. In each country, the regulation of insider trading was the outcome of the competing interests of the state, the industry and small investors. The different social and political contexts in Canada and China have led to different enforcement mechanisms in the two countries.

In Canada, businesses play the prominent role in the operation of securities regulators. The facts that politicians, regulators and corporations frequently share ideological perspectives that posit profit maximization as the ultimate goal, and that applying the law to corporations may constitute “government interference,” are important in understanding this approach. Despite the fact that insider trading is increasingly recognized by the broader public as a serious offence, the corporate sector in Canada has enjoyed much more success than its Chinese counterpart in persuading lawmakers and



government to retain lenient insider trading legislation. Although the provincial commissions in Canada may purport to be neutral, they have absorbed the values of the business community and their policies are influenced, albeit indirectly, by corporate insiders. No direct evidence is forthcoming from the present study to support this proposition, but it is a possible inference from the findings. From the history, the small number of insider trading cases, the policy documents of the commissions and the interviews, it is clear that regulators in Canada generally adopt a gentle compliance model toward those they are regulating. Many Canadian securities officials have sympathetic views on insider trading offenders and choose to forgive their illegalities.

In contrast, China has adopted a much more state-centred approach to insider trading than has Canada. In China, where state-owned securities account for about 70 percent of the country's issued shares, the government has assumed a significant role in enforcing insider trading laws. With the economic, political and social structure of the country in transition in the recent decade, insider trading law must move with these changes to adapt to the new political economy of white-collar crime and the new balance of power between the political elites, the new capital class and small public investors. Folsom and Minan (1989: 15) point out that China's legal reconstruction was initiated mainly for economic reasons. However, a "double-track" government control system, with economic profits on the one hand, and political stability on the other, exercises a parallel system of regulation over insider trading. The Chinese government faces tremendous challenges in managing its vast economic changes while simultaneously trying to maintain political stability. Unsurprisingly, therefore, changes in the political and economic environment have important impacts on policies and practices (Friedrichs

1996: 285). When trading illegalities did not cause uneasiness and anger among investors, the CSRC failed to pursue many cases. The much greater pressure over recent years from public investors and foreign investors in the Chinese economy might reasonably explain why the CSRC has begun to prosecute more insider trading cases. To appease public anger, the CSRC officials have generally denounced insider trading activities and vowed to take harsh measures to punish offenders.

While I have proposed some ideological possibilities above, the focus of the study is on the more directly observable factors in explaining limited enforcement activities in both Canada and China. In Canada, the limitation on the regulators' resources is one such factor. The provincial securities commissions are not endowed with massive personnel and resources to detect every insider trading behaviour. The Canadian commissions rely on industry informants to bring to their attention instances of wrongdoing. A danger arising from the concentration of the regulatory resources on such complainants is that it can be at the expense of law enforcement. A number of worthless or trivial complaints may waste the commissions' limited resources. Furthermore, certain insider trading offences will be discovered only if securities commissions adopt more proactive strategies. The Market Regulation Services Inc, which is supposed to monitor each and every trade in real time every day to help detect insider trading, has been designed to fill in this gap. This program is well-organized, but is still primitive and so far has referred only a limited number of insider trading cases to the securities commissions. While improved efforts to increase cooperation can provide the information that detection depends on, the provincial commissions should further explore more effective ways in

which regulatory officers can expose offences that are relatively immune from self-regulatory surveillance.

Although the Chinese securities commission has the similar problem of insufficient resources, insufficient power to investigate unearthed insider trading cases is a more challenging problem. The major reason why only a few insider trading cases were pursued and reported in China is not that the CSRC did not discover many insider trading activities, but rather that the regulator worried about the possible negative effect of aggressive enforcement on the relatively new and delicate Chinese markets. Through various intelligence technologies, the CSRC, in fact, has detected a large number of insider trading offences in the past decade, although it decided not to deal with all such cases through legal proceedings due to the above political and economic considerations. According to many observers (for example, McVea 1993: 62), however, healthy development of securities markets in the long run depends upon effective enforcement against illegal activities. Although punishing trading illegalities might create certain short-term turbulence for stocks, the prevalence of such offences will easily ruin market reputation and cause market crises and even market collapse. It is suggested that fair, efficient and transparent securities markets through consistent law enforcement are essential to China's successful transition from the old planned economy to a market economy and to its integration into the world market. It is also suggested that the CSRC, as a regulatory agency, be more independent from the party system to pursue insider trading cases.

While I note the CSRC's inappropriate attitudes towards insider trading cases, the strengths of its detection strategies should not be overlooked. Although the CSRC's

model of combining various reactive and proactive methods is still not perfect at this stage, it has demonstrated its usefulness in discovering insider trading activity. In particular, bounties and compensation for loss are two powerful incentives for nonculpable insiders, the “whistle-blowers,” to share their information with regulators. The CSRC staff’s regular proactive inspections of listed companies are also important to generate insider trading cases. On the one hand, regulators in both countries need to induce more insider and outsider informers to report suspected trading, by providing them with legal protection and monetary benefits. More importantly, regulators should also adopt more proactive strategies to detect insider trading offences, by employing more skilled investigators, using advanced technology and exerting regular inspections. The federal and provincial governments in the two countries need to provide more financial support to the securities regulators, so that the commissions can recruit new staff, borrow expert investigators from other sectors, and develop training programs for the current staff.

It is necessary for the commissions both in Canada and China to fund comprehensive market surveillance programs, in which commission inspectors can discover insider trading offences by examining the books and records of the registered firms. Such detection efforts can be enhanced by installing sophisticated computer surveillance software systems to track insider trading on-line. For example, in cooperation with stock exchanges, securities commissions can use the electronic system to trigger specific insider trading alerts. With the help of data-mining, client data can be integrated with trade data to identify the involvement of nominee and offshore accounts in insider trading (Illegal Insider Trading Task Force 2003: 25).

In order to explore diverse sources of insider trading cases, securities commissions in Canada and China could also improve inter-agency and inter-market information-sharing and facilitate referrals from not only self-regulatory agencies, but also other social control agencies and programs, such as securities regulators in other jurisdictions, the Federal Department of Justice (the Supreme People's Procuratorate in China), provincial Attorney General's Ministries (provincial Procuratorates in China), the revenue agencies, and the police white-collar crime enforcement programs. Since globalization has made it possible to engage in illegal insider trading across borders, regulators should also cooperate on detection of inside trading involving securities that are inter-listed on markets in different countries. The International Surveillance Group (ISG)<sup>82</sup> has created an "unusual activity" database to assist in identifying inter-market insider trading. The database currently is used only by securities regulators in the U.S. It is suggested that securities commissions in Canada and China participate in the ISG's database to detect possible international insider trading.

It has been found that both Canadian and Chinese regulators are tempted to favour ameliorative discretion towards insider trading cases. In Canada, most cases are resolved by negotiated settlements, which have obvious advantages. Settlements can be carried out by commission staff with relatively little expertise, and involve fewer resources and a shorter period of time. Just as the *OSC Annual Report, 2003* described, "One of our aims is to settle matters without incurring the expense of a full hearing." No doubt such

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<sup>82</sup> The ISG is an information-sharing cooperative governed by a written agreement among its members. It was created in 1983 by the major U.S. securities exchanges to meet the increasing need among these marketplaces to share information regarding securities trading. In 1990, non-U.S. organizations were allowed to join the ISG as affiliate members to facilitate further information sharing. Since then, the ISG has grown to include North American, Asian, and European exchanges, all of which have a common interest in ensuring that the securities and futures marketplaces are regulated effectively and efficiently.

advantages are important factors in making the regulatory policy of favouring cooperation over law enforcement. However, negotiated settlements involving a small sum of money may not have a preventive or deterrent effect on trading practices. To deter wrongdoing the sanctions by settlements would have to be at such a level that insiders would find it more economical to mend their ways than to have regulators dealing with their illegalities.

In China, the CSRC officials normally impose administrative sanctions on the exposed insider trading offenders at a closed-door hearing, under the excuse that some of the offenders' violations are related to state secrets. Many cases which are not yet known to the public are simply referred to offenders' employers for education or disciplinary measures. The CSRC has failed to officially report all the insider trading cases.<sup>83</sup> Those decisions publicized have not been reported in detail. The rationale behind the non-public administrative disposition of insider trading cases is that it is more expedient and convenient to manage without going through due process. Sometimes, such sanctions could be arbitrary, and thus unfair to both the alleged offenders and victimized investors. It is argued that the imposition of administrative penalties without a public hearing amounts to an infringement of the constitutional rights of the alleged violators.<sup>84</sup> Closed-door hearings can also cause corruption problems in administrative proceedings. Furthermore, the CSRC hearing officials normally lack professional knowledge of securities trading to decide insider trading cases. It is suggested that, in order to

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<sup>83</sup> Some published studies show that public disclosure of offenders can and does facilitate the enforcement mechanism with regard to the regulation of insider trading. Obviously, in certain cases, adverse publicity could hit companies' and individuals' self-respect and prestige. Fisse and Braithwaite (1983) considered that the main advantage of formalized disclosure is the effect that it has on deterrence and therefore prevention.

<sup>84</sup> The newly amended Constitution (2004) provides in Article 33 that "the state respects and guarantees human rights."

demonstrate its efforts to join the democratic world, the Chinese government should learn from Canada and enhance transparency and openness of its legal and regulatory systems. Due process is needed to guarantee the fairness of hearings. To strengthen the effectiveness of its enforcement, the CSRC should be bestowed the power to subpoena witnesses and administer oaths or to subpoena documentary evidence in its administrative hearings.

In both Canada and China, criminal prosecution is considered the last resort of the enforcement systems. The Canadian provincial commissions generally maintain that successful enforcement in today's complex trading structure depends upon goodwill and cooperation between businesses and enforcement officers. It is said that prosecution in many cases would be nothing more than a punitive response to wrongdoing, because businesses are basically law-abiding and simply need to be informed or reminded of their legal obligations. White-collar crimes are generally not considered as serious social crimes. Faced with a choice between taking formal regulatory action as opposed to counselling, advising, educating, or even mollifying the offending organization or individual, regulatory officials overwhelmingly avoid the former. In China, although to appease public investors, the CSRC claims that insider trading offences should be more regularly detected and prosecuted, it does not indeed prosecute a substantial proportion of insider trading offences which it detects. Besides ideological and political reasons, the difficulty in proving an insider trading case in courts is a major factor in maintaining a non-prosecution enforcement policy. In both countries, the courts are generally reluctant to convict insider trading offenders. The difficulties in achieving criminal prosecutions have led the commissions to rely on administrative proceedings.

The decision of the securities commissions in both countries to initiate or recommend criminal prosecutions is influenced by their perception of the “seriousness” of an offence, which takes concrete form in factors such as the harm caused to the market, the number of offenders and the sum of money involved in the illegal trading. The BCSC, for example, uses an analytical score card to grade insider trading cases, and pursues the cases with the highest number of points. This standardized method is evidently less arbitrary than other approaches and should be considered as a means for the Chinese regulators to improve their case-processing situation. It is further suggested, however, such techniques should be explicit, constantly applied, publicized and well-adapted to changing circumstances, so that regulators can allocate adequate resources to the strongest cases.

Which enforcement policy is more effective in regulating insider trading illegalities, the prosecution-oriented one or the persuasion-oriented one? Underpinning the prosecution policy of securities commissions is the view that compliance with insider trading laws can be achieved more efficiently by negotiations or internal disciplinary mechanisms than by court proceedings. Certainly it is wasteful of resources and brings the administration of justice into disrepute if criminal prosecutions involve trivial matters, or if they are undertaken when there is little chance of success. The use of criminal sanctions for every violation of insider trading laws would be self-defeating, even if it were administratively possible. However, there is no evidence that negotiations or minor internal disciplines are more efficient than prosecution in reforming insider trading behaviour. Similarly, there is no evidence that prosecuting more offenders will not deter insiders from engaging in such illegal acts. Some people (for example, Seyhun 1992:



149-171) argue that increased enforcement does not lead to a decline of insider trading activities. However, they neglect the fact that prosecution-oriented securities regulators, such as the SEC, normally engage in more detection work and discover a greater number of insider trading cases than does the average securities commission. Some officials of securities commissions recently argue that the incidence of insider trading will be reduced through successful law enforcement (Brown 2003). There are good reasons to worry that, without sufficient prosecutions, many wayward insiders may continue their illegal trading if they find it profitable to do so. Prosecution is at least a necessary reminder to traders that they must exercise constant diligence to avoid committing insider trading.

As the infrequency of insider trading cases in the two countries shows, however, the absence of regular and consistent law enforcement against insider trading offences is a significant problem in both China and Canada. Although some high profile cases have been pursued in both nations recently, the most intensive investigative efforts are directed toward the smallest and weakest individuals and organizations. These people and businesses lack the power to block investigations, and the resources to conceal crimes well. In contrast, the largest and most powerful organizations enjoy the best relations with regulatory officials. They are also the most likely to challenge legally any investigation or sanction. As a practical matter, cases brought against insiders of large corporations are more complex and sensitive, and are likely to affect the political image of the government.

Both Canada and China have asserted that they are determined to strengthen their laws and regulations against insider trading offences. Canada moved to address the

problem of insider trading crimes by committing more resources to prosecute illegal insider trading, and by introducing tough penalties, although ideological, political and economic constraints remain. The proposed legislation (Bill C-46) in June 2003 by former Justice Minister Martin Cauchon made it an offence under the *Criminal Code* to trade shares on inside information not disclosed to the public. The bill, which comes in the wake of a string of corporate scandals in the United States, including Enron and WorldCom, includes a maximum penalty of 10 years in jail for insider trading offences. The Canadian federal government will create nine enforcement teams comprising police, lawyers and other investigative experts. The units will be located in the country's four major financial centres -- Toronto, Vancouver, Montreal and Calgary. As David Brown, chairman of the Ontario Securities Commission, stated that the bill would provide good opportunity to increase the effectiveness of criminal enforcement of insider trading and other securities offences (Brown, 2003, November 12). The Bill C-46 died on the Order Paper when the second Session of the 37<sup>th</sup> Parliament ended on November 12, 2003. However, it was revived as Bill C-13 in the third session of the 37<sup>th</sup> Parliament and received Royal Assent in March 2004 (Rudnicki 2004, March 30), although was not yet proclaimed into force as of April 26, 2004.

China, too, has begun to disclose and prosecute more insider trading offenders and impose more severe penalties on them. The CSRC, the Public Prosecution Offices and the courts are becoming more active under the pressure of the public. On March 10, 2003, the CSRC secured the only jail sentence for insider trading to date against Ye Huanbao, the former chief executive of Shenzhen Real Estate Group, a large state-owned company in China. Ye was given a three-year sentence for insider trading and a six-year

sentence for abuse of power. However, it is still too early to predict the future trend of insider trading enforcement in China from this one case alone. Political complications and transparency issues will remain substantial hurdles to law enforcement in the coming years.

The potential threat of more severe penalties would unquestionably have a significant deterrent effect on the type of person most likely to come within the purview of anti-insider trading regulation. However, if regulators, courts, and judges choose not to use the considerable arsenal of sanctions they already possess, how can securing even more punitive laws represent an improvement? No matter how determined and powerful the authority charged with the administration of anti-insider trading rules may be, and no matter what resources and expertise the regulators possess, all is likely to be of no avail where businesses have enough power to influence regulators. The effectiveness of future efforts to enforce anti-insider trading provisions will arguably depend upon how independent and impartial is the regulatory authority charged with their administration. Where a government, possessing sufficient determination and independence, wishes to take a stand against insider trading offences, it may possibly impose sufficient punishment through the law or some other method that will exert pressure on corporate insiders to adhere to the prevailing rules. Indeed, as in the case of Britain, the mere threat of governmental intervention through the independent super-regulator, the Financial Services Authority, might conceivably stimulate the various self-regulatory authorities to improve the regulatory scheme. There is also a positive need for greater input from small investors in the formulation of insider trading laws and in the process of their enforcement.

## APPENDIX A - LIST OF ABBREVIATIONS

AMC	Asset Management Corporation
ASA	Alberta Securities Act
ASC	Alberta Securities Commission
BCJ	British Columbia Judgements from Quicklaw
BCSA	British Columbia Securities Act
BCSC	British Columbia Securities Commission
CBA	Canadian Bar Association
CCB	China Construction Bank
CLPRC	Criminal Law of the People's Republic of China
CSA	Canadian Securities Administrators
CSRC	Chinese Securities Regulatory Commission
ECID	Department for Economic Crimes Investigation (China)
ED	Executive Director
OSA	Ontario Securities Act
OSC	Ontario Securities Commission
PEOC	People's Bank of China (Central Bank)
PMCSF	Provincial Measures Controlling Securities Firms (China)
PMFSFB	Provisional Measures Forbidding Securities Fraudulent Behaviour
PRC	People's Republic of China
PROSIT	Provisional Regulations for Oversight of Stock Issuance and Trade
RMB/RMB yuan	Renminbi yuan (Currency in the People's Republic of China; \$100 CAD =630 RMB yuan)
RMSMSIT	Regulatory Measures of Shenzhen Municipality Securities Issuance and Trade
RMSMST	Regulatory Measures of Shanghai Municipality Securities Trade
SCSC	State Council Securities Commission
SEC	Securities and Exchange Commission (U.S.)
SFO	Securities Fraud Office
SLPRC	Securities Law of the People's Republic of China
SRO	Self-Regulatory Organization
VC	Vice-Chair

## APPENDIX B – CODING SHEET

ID# \_\_\_\_\_

Q. 1. Jurisdiction: 1. BC 2. Ontario 3. Alberta 4. China

Q. 2. What were the actions of enforcement?

- 1) Administrative charges
- 2) Quasi-criminal charges
- 3) Criminal prosecutions

Q. 3. Date of earliest offence/misconduct

Q. 4. Date of latest offence/misconduct

Q. 5. Date of charge

Q. 6. Date of hearing/trial

Q. 7. Charge

- Insider trading
- Tipping

Q. 8. Occupation/Position of accused

Q. 9. Outcome of initial trial/hearing

- Convicted
- Acquitted
- Commission found misconduct
- Commission found no misconduct
- Settlement

Q. 10. Sentence outcome

- Jail How long? \_\_\_\_\_
- Fine How much? \_\_\_\_\_
- Commission fine How much? \_\_\_\_\_
- Commission suspension
- Commission prohibition from trading
- Commission reprimand

Q. 11. Appeal

1. to Court of Appeal
2. to Superior Court from Commission
3. to Superior Court from Provincial Court
4. Not appealed
5. not known

Q. 12. Outcome of appeal

1. For accused
2. For Crown
3. For Commission
4. New trial ordered

Q. 13. Sentence outcome of appeal

1. Sentenced increased
2. Sentenced decreased
3. Sentence maintained
4. Not an issue

## APPENDIX C – INSIDER TRADING CASES IN CANADA (1985-2003)

Case Names, Citations and Commissions	Details of Insider Trading Case	Summary of Decision	Date of Trades/ Date of Decision
<p><i>Busby (Re)</i> BCSC, BCSECCOM 182, March 19, 2004 (www.bcsc.bc.ca) (BCSCn) (QL)</p>	<p>It is alleged that, Donald Wayne Busby, a director, chairman and CEO of Hilton Petroleum Ltd., traded 375,000 or more securities of Hilton through an account held in the name of a family member, with knowledge of an undisclosed material fact in relation to the securities of Hilton existed or an undisclosed material change in the affairs of Hilton occurred.</p>	<p>In the settlement, Busby had to pay 85,000 in fines and costs and was banned from trading securities for four years.</p>	<p>March 13 to March 21, 2001/March 19, 2004</p>
<p><i>In the Matter of Daniel Dui</i>, OSC Settlement Agreement, March 3, 2004 (www.osc.gov.on.ca)</p>	<p>Daniel Duic made approximately \$1.9 million from trading on the former managing director at the Royal Bank-owned brokerage Andrew Rankin's inside information related to pending corporate mergers and acquisitions.</p>	<p>In a settlement with the OSC, Duic agreed to pay \$1.9 million and another \$25,000 in fines and costs and testify against Rankin if subpoenaed. Duic's penalty also included lifetime trading ban in Ontario and a ban from ever becoming a director of a public company.</p>	<p>October 1999-March 2001/March 3, 2004</p>
<p><i>Donnini (Re)</i> (2002), 25 OSCB 6225 #38/02 (OSC) (QL)</p> <p><i>Donnini v. Ontario Securities Commission</i> [2003] O.J. No. 3541 (OntSupCtJus) (QL)</p>	<p>It was alleged that Piergiorgio Donnini, Yorkton Securities Head Trader, committed insider trading in shares of Kasten Chase Applied Research in early 2000. The OSC panel concluded that Donnini possessed material information when he traded more than 500,000 shares in Kasten.</p>	<p>In addition to the 15-year trading ban, the OSC ordered Donnini to pay \$186,000 in investigation costs.</p> <p>On appeal, the Ontario Divisional Court upheld the Commission's finding of liability, but reduced to four years the suspension. The OSC Staff plan to seek leave to appeal the Court's decision.</p>	<p>February 29 to March 1, 2000/September 1, 2002;</p> <p>September 15, 2003</p>

Case Names, Citations and Commissions	Details of Insider Trading Case	Summary of Decision	Date of Trades/ Date of Decision
<i>Brewer (Re)</i> [2003]B.C.S.C.D. No. 745 (BCSCn) (QL)	Brewer was a director and officer at St. Elias Mines Ltd.. St. Elias had received raw assay results on a mineral prospect in northern Peru that were far below the trench excavation results announced in a news release. With knowledge of the inside information, he sold 15,500 shares and avoided \$1,940 in losses by trading prior to the disclosure of the assay results.	In the settlement, Brewer paid the Commission the sum of \$6,940 as a voluntary payment. He received a two-year prohibition from becoming or acting as a director or officer of any reporting issuer.	November 13 and 14, 2001/August 28, 2003
<i>Seto (Re)</i> [2003] A.S.C.D. No. 270 (ASC) (QL)	Richard Harry Seto, a director and CEO of Inter-Tech Drilling Solutions Ltd., purchased securities of Inter-Tech with knowledge of a undisclosed material fact with respect to a possible business transaction or alliance relating to Inter-Tech. He also tipped the inside information to his sister for illegal insider trading.	Richard Harry Seto received a two-year prohibition from becoming or acting as a director or officer or as both a director or officer of any issuer. He paid an administrative penalty of \$5,000, and paid \$10,000 for the costs of the investigation.	March 24, 1998/February 19, 2003
<i>R. v. M.C.J.C. Holdings Inc.</i> [2000] O.J. No. 4391 (OntCtJus) (QL)  <i>In the Matter of M.C.J.C Holding Inc. and Cowpland</i> (OSC) (www.osc.gov.on.ca)	The OSC alleged that M.C.J.C. holdings (Cowpland's private company) sold the shares with knowledge of material facts that were not widely known – specifically that Corel would fall short of quarterly sales figures. Between August 11, 1997 and August 14, 1997, Cowpland sold 2.4 million shares in Corel – worth more than \$20 million – four weeks before the company issued an earnings warning. That warning sent the stock into a major decline. Shareholders suffered a \$32-million US loss. The OSC estimated that the insider trading saved Cowpland \$1,390,000.	M.C.J.C. pleaded guilty in the Ontario Court of Justice. The judge imposed a \$ 1 million penalty against M.C.J.C. Holdings Ltd.  In December 2003, the OSC reached a settlement with Cowpland. He has been fined \$50,0000 and is banned from acting as a director of any public company for the next two years. In addition, he and M.C.J.C. are formally reprimanded, and M.C.J.C. must pay \$75,000 in costs.	11 to 14 Aug. 1997/ February 12, 2002,  December 12, 2003



<p><i>In the Matter of Richard Théberge</i> (OSC) (www.osc.gov.on.ca)</p>	<p>It was alleged that Théberge purchased 6,500 shares of CML Corporation with the inside information from his father, the chairman of the board, that the company would be a takeover target. He sold the shares after the takeover announcement, for a profit of approximately \$15,000.</p>	<p>In the settlement, Richard Teberge was reprimanded, forced to cease trading for 120 days and pay a fine of \$25,000 to OSC.</p>	<p>May 2000/June 22, 2001</p>
<p><i>Patterson (Re)</i> [2000] B.C.S.C.D. No. 155 (BCSCn) (QL)</p>	<p>In 1990, Patterson set up a trust in his name through a company based in Jersey in the United Kingdom. Through the trust, Patterson acquired Bray International, a company incorporated in the British Virgin Islands. Between 1990 and 1996, Patterson directed Bray through his trust to buy and sell shares in four companies with which he was an officer or director throughout 1990s. Patterson also failed to disclose his involvement with Bray to the Vancouver Stock Exchange during the purchase of warrants and shares through private placements in two of the four companies.</p>	<p>In the settlement (without hearing), Mr. Patterson agreed to pay a \$50,000 fine. He was also banned from the market for 15 months and must resign any positions he holds as an officer or director of a publicly traded company.</p>	<p>1990 to 1996/October 13, 2000</p>
<p><i>R. v. Harper</i> [2000] O.J. No. 3664 (OntCtJus) (QL)</p> <p><i>R. v. Harper</i> [2002] O.J. No. 8 (OntSupCtJus) (QL)</p> <p><i>R. v. Harper</i> [2003] O.J. No. 4196 (OntCA) (QL)</p>	<p>Harper, president of Golden Rule Resources, was charged with trading approximately \$4 million worth of the company's shares from January to May 1997, with the knowledge of an undisclosed material information that some mining assay results showed there was little gold in one of the company's mines in Indonesia.</p>	<p>Harper was sentenced one year of imprisonment and fined a total of \$4 million.</p> <p>Harper appealed to Ontario Superior Court of Justice which reduced the sentence to six months' imprisonment and \$2 million fine.</p> <p>The Ontario Court of Appeal upheld the Crown's appeal on the application of the fine provisions for insider trading offences, but affirmed the fine imposed by the summary conviction appeals court judge of \$2 million, in addition to a \$400,000 victim fine surcharge.</p>	<p>Jan. to May 1997/ 19 Sept.2000</p>

<p><i>BCSC v. Kathryn Gannon</i> Weekly Summary, Edition 00:25, p. 20 NR#00/27 (BCSCn) (QL)</p>	<p>Kathryn Gannon was charged with insider trading both criminally and civilly in the U.S.</p>	<p>In the settlement, she was prohibited from acting as a director, officer to publicly traded companies.</p>	<p>No info/June 23, 2000</p>
<p>In the Matter of W. Norman Maxwell (<i>OSC</i>) In the Matter of Antonino Candido(<i>OSC</i>) In the Matter of John Dzambazov (<i>OSC</i>) (www.osc.gov.on.ca)</p>	<p>It was charged that Maxwell, Candido and Dzambazov, insiders of Megalode Corporation, had engaged in insider trading of the Megalode shares and filed false financial statements for the company. Maxwell sold 200,000 Megalode shares for \$603,000 and sold 492,900 Megalode shares in the name of his wife for 828,596. Candido sold 70,000 shares for \$44,718. The OSC first dismissed the case on December 7, 1996, and recharged the respondents in 1999.</p>	<p>In the settlement, the three respondents admitted that they had filed false financial statements. Maxwell and Candido admitted the insider trading allegations. Maxwell was banned from trading for ten years, Candido for eight years and Dzambazov for 6 years. The trio were also prohibited from acting as a director or officer for ten years.</p>	<p>1992/April 12, 2000</p>
<p><i>Robinson (Re)</i> (1996), 19 OSCB 2643 #20/96 (OSC) (QL)</p> <p><i>Robinson v. Ontario (Securities Commission)</i> [2000] O.J. No. 648 (OntSupCtJus) (QL)</p>	<p>Terence Robinson, the Toronto stock promoter was charged with illegal insider trading in connection with three over-the-counter penny stocks.</p>	<p>Prosecutors dropped criminal charges against him in 1994. In 1996, the OSC imposed a lifetime trading ban against him for market manipulation.</p> <p>His appeal to the Ontario Superior Court of Justice was dismissed.</p>	<p>1989 and 1990/June 20, March 14, 1996</p> <p>February 29, 2000</p>
<p><i>Seifert (Re)</i> Weekly Summary, Edition 99:51, p. 42 (BCSCn) (QL)</p>	<p>It was alleged that securities lawyer Serfeit and former president of Arakis Energy Alexander traded hundreds of thousands of dollars worth of Araki Energy shares with knowledge of undisclosed material facts.</p>	<p>In a settlement, Seifert agreed to a 12-year trading ban and paid \$450,000 in fines and costs to the BCSC after admitting the insider trading allegation. Alexander agreed to a 20-year trading ban and paid a total of \$1.2 million in fines and costs.</p>	<p>July and August 1995/December 9, 1999</p>



<i>Naxos Resources Ltd. (Re)</i> (1999), 8 ASCS 921 #08/14 (ASC) (QL)	The Staff alleged that three of the respondents (Jimmy John, Sidney Kemo and Ian Gordon, directors and/or officers of Naxos) purchased and sold securities with knowledge of undisclosed material facts and material changes in the affairs of Naxos.	Allegations not sustained	June 1, 1991 to June 17, 1997/March 18, 1999
<i>George (Re)</i> (1999), 22 OSCB 717 #04/99 (OSC) (QL)	OSC staff accused stockbroker Gary George of illegally short-selling shares of a Calgary seismic firm in 1995. It was alleged that Gary George sold short 2,300 shares of Solid State on 29 May 1995 after attending a meeting where inside information relating to Solid State was discussed.	Allegations not sustained	May 29 to 30, 1995/January 26, 1999
<i>Canadian 88 Energy Corp. (Re)</i> (1997), 20 OSCB 5247/5248 #42/97 (OSC) (QL) <i>Canadian 88 Energy Corp. (Re)</i> (1997), 6 ASCS 2843 #06/42 (ASC) (QL)	It was alleged that Canadian 88 Energy Corp., West Central Capital Corporation, Greg Noval and David DiPaolo colluded in the purchases and sales of common shares of Morrison Petroleum Ltd. by West Central prior to the announcement by Canadian 88 of its intention to make a formal takeover bid for Morrison. A joint hearing was held by the Ontario and Alberta Securities Commissions.	Under the settlement agreement, Canadian 88 received a reprimand, Mr. Nova received a one-year trading ban and each of West Central and Mr. DiPaolo received a six-month trading ban. The respondents also agreed to pay \$200,000 to cover the costs in the matter.	December 1996/ October 15, 1997
<i>Rose (Re)</i> (1997), 20 OSCB 100#02/97 (OSC) (QL)	It was alleged that, Rose, a market maker in the securities of Paragon at the same time as he was negotiating the private placement of the company, was in a conflict-of-interest position. His acts thus constituted illegal insider trading contrary to section 76 of the Act.	In the settlement, Rose paid \$30,000 in fines and costs and received a two-year trading ban.	October 1993/January 7, 1997
<i>R. v. Maxwell</i> [1996] O.J. No. 4832 (OntCtProvD) (QL)	Former Megalode president David Conforzi originally pleaded guilty on September 11, 1996, to illegal insider trading and publishing misleading financial statements. He avoided a loss of about \$321,000 in 1993 and 1994 by selling shares of Megalode, an over-the-counter stock promotion.	Conforzi and two other men were ultimately acquitted the same year of illegal insider trading. The reason: the OSC laid charges under an outdated version of the Ontario Securities Act.	February 1, 1993, and July 30, 1994/December 5, 1996

<p><i>Pinchin (Re)</i> Weekly Summary, Edition 96:41, p. 7, COR#96/222 (BCSCn) (QL)</p>	<p>Pinchin conducted undisclosed take over bids of Consolidated Brightwork Resources Inc. and Keywest Resources Ltd. During the periods, he purchased and sold shares of Brightwork and Keywest with knowledge of such undisclosed material changes.</p>	<p>The BCSC imposed 25-year trading ban and 25-year director/officer ban on Pinchin. He was ordered to pay \$50,000 administrative penalty. He and his two companies also paid \$54,723.38 in costs.</p>	<p>December 1992 and April 1993/October 11, 1996</p>
<p><i>Ayre (Re)</i> Weekly Summary, Edition 96:40, p. 36 (BCSCn) (QL)</p>	<p>Calvin Edward Ayre, a director and President of Bicer Medical Systems Inc., knowing of material facts or material changes, purchased and sold in excess of 4 million Bicer shares.</p>	<p>In the settlement, Ayre consented to orders banning him from the market for 20 years. He also agreed to pay \$10,000 to the BCSC.</p>	<p>August 16, 1990 to July 2, 1991/October 3, 1996</p>
<p><i>Hunter (Re)</i> Weekly Summary, Edition 95:44, p. 6 COR#95/172 (BCSCn) (QL)</p>	<p>James Jonathan Hunter, a newsletter publisher who promoted speculative investments, engaged in illegal insider trading in Cal Graphite Corp. shares, by selling shares with knowledge of undisclosed material facts, namely his agreement with Stirling, former president of Cal. and his option with Handelskredit Bank AG.</p>	<p>The BCSC imposed a 10-year prohibition from trading securities and from being a director or officer of a company on Hunter. Hunter was also ordered to pay the costs of the hearing.</p>	<p>1987 and 1988/November 9, 1995</p>
<p><i>Slightham (Re)</i> Weekly Summary, Edition 95:22, p. 45 (BCSCn) (QL)</p>	<p>Slightham, president, CEO and a director of Beauchamps and president and a director of Beaufield, traded in the shares of Beauchamps and Beaufield with the knowledge of undisclosed material facts or material changes which had not been generally disclosed.</p>	<p>In the settlement, Slightham was prohibited from being a director or officer of any reporting issuer or of any issuer which provides management, administrative or consulting services to a reporting issuer for 25 years. Slightham also paid the sum of \$30,000.</p>	<p>1990 to 1994/June 2, 1995</p>

<p><i>Aatra Resources Ltd. et al. (Re) Weekly Summary, Edition 93:37, p. 11 COR #93/152 (BCSCn) (QL)</i></p>	<p>Henry Huber engaged in improper insider trading. And made a substantial profit, by selling his 40,000 Aatra shares with knowledge that the distribution had collapsed.</p>	<p>Huber was prohibited from becoming or acting as a director or an officer of any issuer for a period of 10 years. His registration was cancelled. He also paid prescribed fees or charges for the costs incurred by the Commission and the Superintendent.</p>	<p>September 1989/September 20, 1993</p>
<p><i>In the Matter of George Hariton (1994), 17 OSCB 2971 #25/94 (OSC) (QL)</i></p>	<p>George Hariton, officer of Bell Canada, was advised the termination of negotiations between Bell, BCE and SHL. He traded on this undisclosed information and made a profit of \$1,100.</p>	<p>A joint settlement agreement was reached. He was barred from trading for six months and ordered to pay \$3,300.</p>	<p>June 10 to July 14, 1992/June 17, 1994</p>
<p><i>Faulkner (Re) Weekly Summary, Edition 94:22, p. 18 COR #94/073 (BCSCn) (QL)</i></p>	<p>The BCSC Staff alleged that Harry Claude Faulkner, former President and director of International Shasta Resources Ltd., traded in the shares of Shasta with knowledge of undisclosed information (the renewal of Harco's management contract and the payments to Faulkner and Harco).</p>	<p>Faulkner was prohibited from becoming or acting as a director or an officer of any issuer for 15 years. He was also forced to pay the costs incurred by the Commission.</p>	<p>May 1, 1987 to September 29, 1988/May 27, 1994</p>
<p><i>Cragnotti et al. (Re) (1993), 16 OSCB 6311 #51/93 (OSC) (QL)</i></p>	<p>OSC Staff accused the head of an Italian holding company of illegal insider trading and manipulating the stock price of packaging company Lawson Mason Group Ltd.</p>	<p>A joint settlement agreement was reached. Sergio Cragnotti was banned for life from acting as an officer or director of an Ontario company and paid a penalty of \$2.7 million.</p>	<p>September 4, to October 15, 1992/December 16, 1993</p>
<p><i>Axagon Resources Inc. et al (Re) Weekly Summary, Edition 93:25, p. 34 COR #93/105 (BCSCn) (QL)</i></p>	<p>The BCSC Staff alleged that Steven Jeffrey Greenwald and Jay Robin Greenwald traded Axagon shares with knowledge of undisclosed material facts. Their insider reports indicate that both Greenwalds were trading in Axagon shares after the alleged misrepresentations had been made.</p>	<p>The BCSC extended temporary orders against the Greenwalds prohibiting them from trading in B.C. until the Staff completed investigation. But no further information was reported so far.</p>	<p>Mid-April to late-August 1992/June 25, 1993</p>

<p><i>Seakist Overseas Limited et al. (Re)</i> (1993), 16 OSCB 1959 #17/93 (OSC) (QL)</p>	<p>It was alleged that DeGroot and various associates used inside information to profit from short selling three million Laidlaw shares worth \$61.2 million. They had knowledge that Laidlaw's earnings for the last quarter of 1990 and the early 1991 were unusually poor. The respondents made approximately \$16.5 million in profits.</p>	<p>In the settlement with the OSC, DeGroot, Herbots and Seakist paid collectively \$23 million in fines and costs. The three respondents also received five-year trading bans. Walker paid \$304,286 (equal to his commission on the short sale) and retired from the broker industry.</p>	<p>Jan. to Mar. 1991/28 Apr. 1993</p>
<p><i>OSC v. Mentor Exploration and Development Co. Ltd. and Paul Penna (Re)</i> (1992), 15 OSCB 849 #8/92 (OSC) (QL)</p>	<p>President Paul Penna of Agnico-Eagle Mines Ltd., Goldex Mines Ltd. and Mentor pleaded guilty to buying 6,000 shares and 9,500 warrants of Goldex Mines Ltd., an affiliate of Agnico-Eagle, using undisclosed information.</p>	<p>He was fined \$5,000 by the court. He also reached a settlement with the OSC to make a voluntary contribution of \$2,500 to defray a portion of costs incurred by the OSC.</p>	<p>November 7, 1990/February 12, 1992</p>
<p><i>R. v. L. Woods</i> [1994] O.J. No. 392 (OntCtGD) (QL)</p>	<p>Woods, a director of Petco Engine Technology Corporation, was charged with illegal insider trading for he advised his long-standing business associate, former Liberal Cabinet minister Richardson, to sell short shares in Petco in February 1989. The profit from the short sale was \$229,575.</p>	<p>On October 5, 1990, Woods was convicted and fined \$15,000. His appeal of this conviction was dismissed and the Crown's appeal of his sentence was allowed. The fine was set aside and a 90 days imprisonment imposed. Woods' application for leave to appeal that decision was denied. Richardson earlier agreed to pay \$550,000 and was prohibited from trading securities for three years. Petco was fined \$100,000.</p>	<p>February 1989/February 24, 1994</p>
<p><i>Kates, Paul A. (Re)</i> (1992), 15 OSCB 417 #4/92 (OSC) (QL)</p>	<p>OSC Staff accused director Paul Kates of selling Standard's stock before the public was told of problems at its trust arm. The allegation was part of broader accusations that Standard had issued misleading financial statements before collapsing.</p>	<p>Mr. Kates paid a \$12,000 penalty as a part of a settlement and was banned from acting as an officer or director of any public company for two years.</p>	<p>July 26, 1990/November 22, 1991</p>

<p><i>OSC v. G. Condy and W. Meyer</i> (Ontario Provincial Offences Court) (1991), 14 OSCB 670 #7/91 (QL)</p>	<p>It was alleged that, Gloria Condy, a secretary of Maple Leaf Gardens Ltd., purchased one hundred shares through broker Meyer, before a public announcement of a dividend for shareholders of the company. Condy made a profit of approximately \$700. It was alleged that Meyer also broke the insider trading law for buying the shares for Gloria Condy because he knew the order was based on inside information.</p>	<p>Condy pleaded guilty to Ontario Provincial Offences Court. Condy and Meyer each fined \$1,200.</p>	<p>July 1990/ February 12, 1991</p>
<p><i>BCSC v. B.C. Endowment Fund</i> Weekly Summary, Edition 93:36, p. 1 NR #93/8 (BCSCn) (QL)</p>	<p>BCSC undertook a reviewing to determine whether the B.C. Endowment Fund's purchase of MacMillan Bloedel shares was made with knowledge of undisclosed material information concerning MacMillan Bloedel and the Clayoquot Sound Landuse decision.</p>	<p>Dismissed</p>	<p>February 9, 1993/September 10, 1993</p>
<p><i>OSC v. L. Saliga</i> (1992), 15 OSCB 2789 #24/92 (QL) (Ontario Court (Provincial Division) (unreported court case)</p>	<p>Ignac Saliga was charged with insider trading for using insider information to buy shares in Corby Distilleries which was targeted for takeover in 1989 by distiller Hiram Walker. Saliga made a total profit of \$18,387.50. The charge was dropped after a closed-door negotiation between defence lawyers and a prosecutor for the OSC.</p>	<p>Saliga pleaded guilty to the court. He was fined \$36,000 by the court.</p>	<p>February 1989/ June 10, 1992</p>
<p><i>Greenwell Resources Corp.(Re)</i> Weekly Summary, Edition 89:125 (BCSCn) (QL)</p>	<p>Harold Dale Baker, corporate secretary of Greenwell, and Thomas Rodney Irving, a director of Greenwell, purchased its securities with knowledge of an undisclosed material fact in relation to Greenwell.</p>	<p>The BCSC withdrew the Vancouver Stock Exchange trading rights of Baker and Irving, and banned them for two years from acting as officers or directors of any public company.</p>	<p>August 21 to 26, 1986/June 19, 1989</p>



<p><i>Mitton (Re) Weekly Summary, Edition 88:101 (BCSCn) (QL)</i></p>	<p>Janet Mitton, a director of Maximus, admitted that she facilitated breaches of the Securities Act by her husband Michael Mitton, including illegal insider trading in the shares of Maximus. She informed her husband of certain undisclosed material facts in the affairs of Maximus.</p>	<p>In the settlement, Janet Mitton received an enforcement order in which she was prohibited from acting as a director or officer of any B.C. company for 20 years. Janet Mitton was charged under the B.C. Offence Act with breaching the enforcement order on January 27, 1997.</p>	<p>November 1987/November 14, 1988</p>
<p><i>Unicorp Canada Corp. (Re) (1986), 9 OSCB 40 #1/86 (OSC) (QL)</i></p>	<p>The actions of Unicorp and Gordon during Unicorp's bitterly contested takeover of Union Enterprises Ltd. resulted in a cash bid for a privileged group of institutional shareholders and a lower-value share swap for others. Gordon was accused of improperly tipping information to certain clients and trading with undisclosed information.</p>	<p>In a settlement with the OSC, Unicorp paid a \$6 million penalty and Gordon paid \$1.1 million to compensate shareholders of Union other than Unicorp.</p>	<p>December 10, 1984 to March 15, 1985/December 31, 1985</p>
<p><i>OSC v. A.Rankin CBC News, February 5, 2004.</i></p>	<p>Andrew Rankin, the former managing director of mergers and acquisitions at the Royal Bank-owned brokerage, was charged with 10 counts of insider trading related to pending corporate mergers and acquisitions. Rankin's childhood friend Daniel Duic made approximately \$1.9 million from trading on Rankin's insider information.</p>	<p>In a settlement with the OSC, Duic agreed to pay \$1.9 million and another \$25,000 in fines and costs and testify against Rankin if subpoenaed. Duic's penalty also included lifetime trading ban in Ontario and a ban from ever becoming a director of a public company. The Rankin case's decision pending.</p>	<p>No info</p>
<p><i>OSC v. John Felderhof (1999), 22 OSCB 2951 #19/99 (QL)</i></p>	<p>Felderhof, the former Vice-Chair and exploration chief of Bre-X Minerals Ltd., was charged with eight securities violations among which four counts involving illegal insider trading. The OSC alleged that Felderhof sold \$83.9 million worth of Bre-X shares with undisclosed knowledge about the company.</p>	<p>Decision pending.</p>	<p>April 24 to September 10, 1996</p>

<p><i>ATI Technologies Inc. (Re)</i> (2002), 26 OSCB 526 #04/03 (OSC) (QL)</p>	<p>K.Y. Ho, Betty Ho, Jo-Anne Chang, David Stone, Mary de la Torre, and Alan Rae are alleged to have committed insider trading contrary to Ontario securities law, resulting in more than \$7.9 million in profits or avoided losses and triggering significant tax benefits. Staff of the OSC have given notice of the intent to seek disgorgement of any amounts attained as a result of non-compliance with Ontario's securities law.</p>	<p>Decision pending.</p>	<p>April to May, 2000</p>
<p><i>Siddiqi (Re)</i> BCSC Weekly Report, May 16, 2003 (Website) (BCSCn) (QL)</p>	<p>It is alleged that Fatir Siddiqi traded in securities of AIS, both through his own accounts and through an account registered in his father Shakir Siddiqi's name (together, the Siddiqi Accounts), with knowledge of undisclosed inside information.</p>	<p>Decision pending.</p>	<p>September 14, 2000 to October 12, 2000</p>

## APPENDIX D - INSIDER TRADING CASES IN CHINA (1990-2003)

Time of the decision	Trader	Occupation	Confiscation of illicit profit	Fine	Jail sentence
1994	Xiangfan Trust and Investment Co. (Shanghai)	State-Owned Company	16.7 million RMB yuan	2 million RMB yuan	None
1997	Zhangjiajie Tourism Development Company	State-Owned Company	11.8 million RMB yuan	2 million RMB yuan	None
1997	Yang Zezhong	General Manager, Zhangjiajie Tourism	None	50,000 RMB yuan	None
1997	Li Jianzhang	Deputy General Manager, Zhangjiajie Tourism	None	50,000 RMB yuan	None
1998	Wang Chuan	Vice-Chair, Beijing University Founders Computer Group	610,000 RMB yuan	100,000 RMB yuan	None
1999	Dai Lihui	CEO, Sichuan Top Science and Technology Development Co.	675,700 RMB yuan	150,000 RMB yuan	None
1999	Yu Mengwen	Department manager, Panzhihua Iron and Steel Group	80,000 RMB yuan	50,000 RMB yuan	None

<b>Time of the decision</b>	<b>Trader</b>	<b>Occupation</b>	<b>Confiscation of illicit profit</b>	<b>Fine</b>	<b>Jail sentence</b>
1999	China Motorcycle Group	State-Owned Company	25.4 million RMB yuan	5 million RMB yuan	None
1999	Zhang Min	China Motorcycle Group	None	50,000 RMB yuan	None
1999	Nanfang Securities Company	State-Owned Company	74.6 million RMB yuan	5 million RMB yuan	None
1999	Beida Motor Company	State-Owned Company	850,000 RMB yuan	1 million RMB yuan	None
1999	Xiong Shuangwen	Deputy General Manager, Nanfang Securities Company	None	50,000 RMB yuan	None
1999	Li Chuanhong	President, Beida Motor Company	None	50,000 RMB yuan	None
1999	Wang Wenchao	Deputy Manager, Beida Motor Company			
2000	Gao Fashan	Director, Tianjin Lida Group	2,000 shares (amount unknown)	None	None
2003	Ye Huanbao	CEO, Shenzhen Real Estate Group	None	800,000 RMB yuan	Three years, on appeal
2003	Gu Jian	Director & General Manager, Shenzhen Segit Digital Co.	None	800,000 RMB yuan	Two years, on appeal

## **APPENDIX E – INTERVIEW QUESTIONS WITH SECURITIES REGULATORS**

### ***A. Questions for the Commissioners of the Securities Commissions***

1. Do you see illegal insider trading as a major problem for securities regulators in your jurisdiction?
2. Do you think that illegal insider traders should be dealt with severely? Why or why not?
3. What are the major problems faced by securities regulators in investigating illegal insider trading and enforcing insider trading laws?
4. Is there anything the Commission can do to enhance or improve its ability to better deal with insider trading problems?
5. Are you aware of how insider trading is dealt with in China [Canada]? Do you think China [Canada] could learn anything from Canada [China]?

### ***B. Questions for the Executive Directors of the Securities Commissions***

1. Do you see illegal insider trading as a major problem for securities regulators in your jurisdiction?
2. Do you think that illegal insider traders should be dealt with severely? Why or why not?
3. Could you estimate the percentage of time that your investigators and enforcement staff spent on illegal insider trading over the past two years?
4. What are the major problems faced by securities regulators in investigating illegal insider trading and enforcing insider trading laws?
5. On what basis do you make the decision whether to proceed with any investigation of alleged insider trading offences? What evidence do you need to build an illegal insider trading case? How do you find the evidence?
6. I have looked at the insider trading cases from your commission in the last 15 years. (For British Columbia Securities Commission) It seems that you have only managed one successful administrative prosecution for insider trading, i.e., Doman/Bennett case. (For China) It seems that there has been no successful criminal prosecution for the particular

offence of insider trading so far. Did I miss anything? What factors do you take into consideration when deciding whether or not to charge and prosecute an insider trader criminally or administratively? What type of insider trading offenders are caught and are involved in administrative proceedings and criminal proceedings? Any difference between these two types of offenders?

7. Is there anything the Commission can do to enhance or improve its ability to better deal with insider trading problems?

8. Are you aware of how insider trading is dealt with in China [Canada]? Do you think China [Canada] could learn anything from Canada [China]?

### ***C. Questions for the Enforcement Directors and Staff of the Securities Commissions***

1. Do you see illegal insider trading as a major problem for securities regulators in your jurisdiction?

2. Do you think that illegal insider traders should be dealt with severely? Why or why not?

3. Could you estimate the percentage of time that your investigators and enforcement staff spent on illegal insider trading over the past two years?

4. What are the major problems faced by securities regulators in investigating illegal insider trading and enforcing insider trading laws?

5. On what basis do you make the decision whether to proceed with any investigation of alleged insider trading offences? What evidence do you need to build an illegal insider trading case? How do you find the evidence?

6. I have looked at the insider trading cases from your commission in the last 15 years. (For British Columbia Securities Commission) It seems that you have only managed one successful administrative prosecution for insider trading, i.e., Doman/Bennett case. (For China) It seems that there has been no successful criminal prosecution for the particular offence of insider trading so far. Did I miss anything? What factors do you take into consideration when deciding whether or not to charge and prosecute an insider trader criminally or administratively? What type of insider trading offenders are caught and are involved in administrative proceedings and criminal proceedings? Any difference between these two types of offenders?

7. Is there anything the Commission can do to enhance or improve its ability to better deal with insider trading problems?

8. Are you aware of how insider trading is dealt with in China [Canada]? Do you think China [Canada] could learn anything from Canada [China]?

# APPENDIX F – ETHICS APPROVAL LETTER

## SIMON FRASER UNIVERSITY

OFFICE OF RESEARCH ETHICS



BURNABY, BRITISH COLUMBIA  
CANADA V5A 1S6  
Telephone: 604-291-4370  
FAX: 604-291-4860

December 20, 2001

Mr. Hongming Cheng  
School of Criminology  
Simon Fraser University

Dear Mr. Cheng:

**Re: A Comparison of Illegal Insider Trading in Canada and Post-Communist China**

I am pleased to inform you that the above referenced Request for Ethical Approval of Research has been approved on behalf of the University Research Ethics Review Committee. This approval is in effect for twenty-four months from the above date. Any changes in the procedures affecting interaction with human subjects should be reported to the University Research Ethics Review Committee. Significant changes will require the submission of a revised Request for Ethical Approval of Research. This approval is in effect only while you are a registered SFU student.

Best wishes for success in this research.

Sincerely,

Dr. Hal Weinberg, Acting Director  
Office of Research Ethics

c: ✓ J. Brockman, Supervisor

/bjr

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