Regulation of Insider Trading in Hong Kong

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I. INTRODUCTION

The early 1970s were a period of rapid growth for the Hong Kong economy. The growth fueled large-scale securities speculation, which was reflected in an eighteenfold increase in volume on Hong Kong's stock exchanges between 1969 and 1973. Unfortunately, this growth of the Hong Kong securities market has been accompanied by widespread trading abuses. Controlling these abuses has been problematic. Many business leaders serve as directors of several corporations and trade shares through nominees. At the same time, some securities dealers are generally willing to place their own interests above those of their clients. In addition, great potential for corruption or co-option of government regulators exists. Finally, a number of market observers consider Hong Kong investors unsophisticated gamblers who base their investment decisions on rumors. The combination of these factors makes it difficult to initiate

5. Id. at 338-39.
6. Id. at 338.
7. Id. at 339 n.95. For a description of how regulators may be co-opted by prospective or former employers, see infra text accompanying note 81.
investigations and locate the real offenders when insider trading occurs. This Note will review the attempts of Hong Kong regulators to control the abuse of inside information. These efforts will then be compared to the United States’ system, which has a longer regulatory history, greater investigative facilities, and stronger means of enforcement. Based on this comparison, this Note will suggest rules to improve the effectiveness of the Hong Kong regulatory scheme.

II. BACKGROUND

A. Hong Kong

The behavior of investors in Hong Kong reflects their attitudes towards insider trading. One important factor is that securities trading in Hong Kong, for the most part, is fed by rumors. As a result, trading on accurate information is difficult because investors must distinguish between rumors and facts.

What exacerbates this difficulty is the willingness of Hong Kong investors to gamble when making investment decisions. Between 1972 and 1973 bank lending increased by fifty percent, fueling a stock exchange roller coaster ride during which stock prices quintupled, only to lose half of their value three weeks later. In 1980 the scene repeated itself, leading one commentator to warn:

10. Even those responsible for controlling insider trading have been discouraged by the practical limitations. In 1975 James Selwyn, the Hong Kong Commissioner for Securities, complained:

To really clamp down on insider trading we would have to cover everyone from a company chairman to the office cleaner rummaging through a waste paper basket for information. . . .

For example, if one man who dominates a public company (and there are quite a few in Hong Kong) develops a serious illness and withholds the fact from all but his closest family, how could we prove that subsequent trading in the shares was not transacted by someone with privileged knowledge?


11. See infra text accompanying notes 82-141.

12. A shadow hanging over any discussion of future Hong Kong policy is the expected 1997 takeover of the Colony by the People's Republic of China. While this Note will not touch upon that issue, it should be noted that policy decisions made during the next ten years may influence policy after the takeover.

13. In Hong Kong the term “insider dealing” is used interchangeably with the terms “insider trading” or “inside trading.” In this Note only the latter terms will be used.

14. B.A.K. RIDER & H.L. FFRENCH, supra note 4, at 338; Davies, supra note 9, at 45.

15. M.F. HIGGINS, supra note 8, at 150. See also A.J. YOUNGSON, supra note 2, at 34.

16. A.J. YOUNGSON, supra note 2, at 34.
“When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done.”

Hong Kong’s credibility and security as a modern financial centre and a soundly based industrial economy have been harmed already by excesses of speculation, and further and more extensive damage may be caused in the long run.17

Furthermore, Hong Kong’s general reputation was not helped by the widely shared criticism that the Colony’s brokers and bankers are too self-interested.18

1. Development of the Hong Kong Regulatory System

Because of the uncontrolled speculation and abuse of information in the early 1970s, the Hong Kong Government decided to create a regulatory scheme for the securities market. In 1974 the Government enacted the Protection of Investors Ordinance over little objection. The lack of resistance was probably due to the belief that the statute was directed only at blatantly fraudulent practices.19 The Securities Ordinance,20 proposed by the Hong Kong Legislative Council at nearly the same time, was the source of much more debate before it was finally enacted. The ordinance contained many provisions that upset the previously unregulated securities traders.21 One particular section created a storm of protest—section 140, which dealt with insider trading.22

Section 140 contained strong criminal and civil penalties for insider trading.23 The section was never implemented24 because, according to the Hong Kong Financial Secretary, Parliament was planning to enact anti-insider trading legislation in Great Britain, and the Hong Kong Government wanted to learn from the British experience.25 A more

17. Id. (quoting J.M. Keynes, The General Theory of Employment, Interest and Money 159 (1936)).
18. See A.J. Youngson, supra note 2, at 33; B.A.K. Rider & H.L. Ffrench, supra note 4, at 338.
19. B.A.K. Rider & H.L. Ffrench, supra note 4, at 329. As further discussed below, despite the potential scope of its language, the Protection of Investors Ordinance has never been applied to insider trading. See infra text accompanying notes 58-61.
21. Aside from insider trading, the Ordinance regulated dealers, investment advisers, stock exchanges, and various forms of securities trading. Id. at A45-50.
plausible explanation may be that the Government wanted to legislate against insider trading, thus helping Hong Kong's reputation in the international business community while avoiding the headache of enforcement.  

In 1978 the Hong Kong Government amended the Securities Ordinance, repealing section 140 and replacing it with the current provisions of part XIIA. Part XIIA prohibits certain types of insider trading in securities listed on the Hong Kong Stock Exchange. The types of trading proscribed by the revised ordinance are the following:

(a) when a dealing in the securities is made, procured or occasioned by a person connected with that corporation who is in possession of relevant information concerning the securities;

(b) when relevant information concerning the securities is disclosed by a person connected with that corporation, directly or indirectly, to another person and the first-mentioned person knows or has reasonable grounds for believing that the other person will make use of the information for the purpose of dealing, or procuring another to deal, in those securities.

The body responsible for deciding whether such transactions have taken place is the Insider Dealing Tribunal, an institution created by part XIIA. The Tribunal, which consists of a Supreme Court judge and two other members, must investigate suspected incidents of insider trading at the direction of the Hong Kong Financial Secretary. The Financial Secretary's order may follow a recommendation by the Securities Commission or may be based on suspicions originating elsewhere. The Tribunal has broad discovery powers to assist it in its investigations.

In investigating possible violations of the Ordinance the Tribunal must interpret three phrases contained in part XIIA's definitions of insider trading: "relevant information concerning the securities," "connected with that corporation," and "knows . . . that the other person will make use of the information." The first term describes the information

29. 19 LHK ch. 333, pt. XIIA, § 141B(1).
30. Id. § 141G(1).
31. Id. § 141G(3).
32. Id. §§ 141H(1)-(2).
33. Id. §§ 141K-141L.
34. See supra text accompanying note 29.
that is restricted under the insider trading law. Part XIIA defines “relevant information” as “information which is not generally available but, if it were, would be likely to bring about a material change in the price of those securities.” Unfortunately, this definition is vague. The statute leaves unclear when information is not “generally available” and what would constitute a “material” price change. Reasons for this vagueness may be to afford some discretion to judicial bodies and to avoid a clear rule that might be circumvented by less scrupulous individuals.

Part XIIA restricts the use of relevant information by persons “connected with a corporation.” The Ordinance defines an individual “connected” with a corporation as a director or employee of the corporation, a “substantial shareholder” in the corporation, or a person who has access to relevant information because of a professional or business relationship between that person and the corporation, including a relationship based on an expected transaction involving the person (or the person’s company) and the issuing corporation. Also, a corporation is “connected” if any of its directors or employees has one of these relationships with the issuer. Thus, the potential list of defendants in an insider trading action is quite large.

A connected person who discloses relevant information, however, will only be culpable if the person “knows or has reasonable grounds for believing that the other person will make use of the information.” In other words, a person cannot be a negligent “tipper” of inside information. The Tribunal’s definition of insider trading in In re Hutchison Whampoa, however, requires “the conscious use [of inside information] for the purpose of profit or...the avoidance of loss...or the disclosure of confidential price-sensitive information to a person likely to use the information for that purpose.” Thus, an insider’s liability may depend

35. *Id.* § 141D(1).
36. For example, a press release which is seen by institutional investors might not be “generally available” to individuals. Furthermore, a “material” price change may be different to different investors.
38. *Id.* § 141E(1)(b). The statute defines a “substantial shareholder” as a person holding an interest in the corporation’s equity securities equal to more than 10% of the share capital or more than 10% of the voting power at a general meeting. *Id.* § 141E(3).
39. *Id.* § 141E(1)(c)(i).
40. *Id.* § 141E(1)(d).
41. *Id.* § 141E(2).
42. *Id.* § 141B(1)(b).
on the tippee's state of mind. Unfortunately, the only subsequent decision by the Tribunal did not turn on this issue, and thus shed no light on whether the courts will continue to respect the *In re Hutchison Whampoa* definition. Future tribunals ultimately may apply the scienter requirement to both tips and transactions, so that the legislative intent will not be circumvented.

While the Insider Dealing Tribunal has substantial investigative powers and a large number of potential targets, the results of an inquiry are quite limited. The Tribunal’s report following an investigation can only state if “culpable” insider trading has occurred, who was involved, and the extent of each person’s “culpability.”44 The sole punitive action available to the Tribunal is the public dissemination of its findings.45

“Culpability” is defined by exception—a person is not culpable for insider trading if the transaction meets any of the following conditions:

(a) the sole purpose of the transaction was the acquisition of qualification shares required as a director (or intending director) of a corporation;

(b) the transaction represents the bona fide performance of an underwriting agreement regarding the securities; or

(c) the transaction represents the bona fide performance of the person’s duties as a personal representative, liquidator, receiver, or trustee in bankruptcy.46

In addition, a person may not be culpable for a trade if his or her purpose was not primarily “the making of a profit or the avoiding of a loss (for himself or another) by the use of relevant information,”47 or if the person entered the transaction as another person’s agent, without giving advice on (or actually selecting) the securities involved.48 This exception leaves the scienter question previously discussed49 open to the Tribunal’s discretion.

Part XIIA creates a special exception to corporate culpability. If a director or employee of a corporation possesses inside information regarding certain securities, and the corporation subsequently trades those securities, the corporation will not be found culpable under the following circumstances:

44. 19 LHK ch. 333, pt. XIIA, §§ 141H(3)-(4).
45. *Id.* § 141I. A violative transaction cannot be voided after a finding of culpability. *Id.* § 141A(2).
46. *Id.* § 141C(1).
47. *Id.* § 141C(3).
48. *Id.* § 141C(4).
49. *See supra* text accompanying notes 42-43.
(a) the decision to trade the securities was made on behalf of the corporation by someone other than the person possessing the information;
(b) the corporation had internal controls designed to avoid the transmission of inside information or investment advice between the person possessing the information and the person making the trade decision; and
(c) no inside information or investment advice was actually communicated between the two persons.50

This exception, known as the "Chinese Wall" defense,51 protects those multiservice financial corporations that maintain internal controls on the flow of inside information and provides an incentive for corporations without such controls to establish them.52

As discussed briefly above, the Insider Dealing Tribunal has made only two inquiries of possible insider trading since 1978. Its first case was an eighteen-month investigation into the possible insider trading of shares of Hutchison Whampoa Ltd. The inquiry, which ended in 1982, resulted in no findings of culpability, in spite of strong evidence that access to inside information had led to major share purchases.53

In 1984 the Tribunal was called upon to review the questionable dealings surrounding a major real estate purchase agreement between International City Holdings Ltd. and Everbright Industrial Co.54 As a result of the investigation, two corporations, a company chairman, a director, and four others were found culpable of insider trading.55 The Tribunal found that the total value of the illegal transactions was HK$39 million (US$4.5 million), an amount considered "tiny" compared to the wealth of the cited parties.56 The insignificance of the reported payoff suggests that either the Tribunal was unable to uncover the full extent of the illegal activity, or that even a small reward is worthwhile when the

50. 19 LHK ch. 333, pt. XIIA, § 141C(2).
51. B.A.K. RIDER & H.L. FFRENCH, supra note 4, at 344.
52. Id.
53. The Tribunal established that an impending change in control of Hutchison Whampoa had been leaked and that an insider had made purchases of Hutchison Whampoa stock before the deal was announced publicly. Bowring, A Deal of Confusion: A Report on Insider Trading Begs More Questions than It Answers, FAR E. ECON. REV., Mar. 26, 1982, at 149, 151.
risk of being caught is marginal.\textsuperscript{57}

2. Potential Means of Regulation

Part XIIA is the only explicit regulation of insider trading in Hong Kong. Although the Hong Kong courts have not applied them, there are other statutes which could be weapons against the improper use of material, nonpublic information. One possible regulation is the Protection of Investors Ordinance,\textsuperscript{58} which was enacted in 1974. This ordinance gives rise to criminal\textsuperscript{59} and civil\textsuperscript{60} liability for inducing someone "by any fraudulent or reckless misrepresentation" to enter into a securities transaction.

The Protection of Investors Ordinance defines a "fraudulent or reckless misrepresentation" in a number of ways, including:

any statement or forecast from which the maker of the statement intentionally or recklessly omitted a material fact, with the result that the statement was thereby rendered untrue, misleading, or deceptive, or, as the case may be, the forecast was thereby not capable of being justified or was thereby rendered misleading or deceptive.\textsuperscript{61}

Insider trading should qualify as an offense under this definition; a person who trades securities while in possession of undisclosed inside information implies that the shares have a certain value that is not reflected in their price.

A second untested provision is part XII of the Securities Ordinance,\textsuperscript{62} which prohibits the use of misleading statements (or omissions) in the sale of securities\textsuperscript{63} and imposes criminal\textsuperscript{64} and civil\textsuperscript{65} sanctions on violators. As with the Protection of Investors Ordinance, insider trading should fall within the scope of part XII because the second party to the transaction will have been misled by statements or material omissions regarding the value of securities sold.

Neither the Protection of Investors Ordinance nor part XII has been applied to insider trading. Both of these regulations, however, bear great

\textsuperscript{57} For a discussion of some of the problems which make discovery of insider trading difficult, see infra text accompanying notes 67-74.

\textsuperscript{58} 19 LHK ch. 335 (1983).
\textsuperscript{59} Id. § 3(1)(a)(i).
\textsuperscript{60} Id. § 8(1)(a)(i).
\textsuperscript{61} Id. § 3(2)(d). See also id. § 8(2)(d).
\textsuperscript{62} 19 LHK ch. 333, pt. XII (1978).
\textsuperscript{63} Id. § 138.
\textsuperscript{64} Id. § 139.
\textsuperscript{65} Id. § 141(1).
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3. The Attraction of Insider Trading in Hong Kong

In the past, there have been three reasons why insider trading has been attractive in Hong Kong. First, it is a common practice in Hong Kong for a business leader to serve as a director of several companies. These multidirectorships provide access to a large store of privileged information regarding each company that might be used for personal financial advantage.

Second, a person trading on inside information in all probability will not be caught. A popular practice in Hong Kong is the use of nominee shareholders to hide the identity of the actual beneficial shareholder. This practice is successful because the identification of beneficial shareholders is not required. The Colony has unsuccessfully attempted to require adequate disclosure of beneficial interests. In 1981 various government officials who complained that they had been administering the securities laws "with their hands tied behind their backs," proposed a variety of disclosure laws. Four years later, the Government drafted what was to be a "sweeping change" from the status quo: a set of regulations that would require a company's directors and substantial shareholders to disclose their beneficial interests in its shares and to register all major transactions involving those shares. These regulations were not enacted as initially proposed. In 1986, however, new stock listing rules were promulgated in preparation for the unification of the four Hong Kong stock exchanges. The formerly ambitious disclosure proposals were "watered-down" to require only biannual disclosure of directors holdings and disclosure of certain "material" transactions by directors "as soon as practicable." Local professional investors thought the new

67. Some people have been known to serve on the boards of forty or fifty different companies. B.A.K. RIDER & H.L. FFFRENCH, supra note 4, at 338-39.
68. Id. at 339.
69. Even then, the chain of nominees can end in a numbered offshore bank account that can be controlled by the beneficial shareholder without fear of government interference. Id.
72. See supra note 28.
73. Wallace, supra note 28, at 12.
requirements were insufficient,\textsuperscript{74} possibly because they still did not deal with the problems of nominees or substantial shareholders who are not directors, nor did they provide for immediate disclosure of nonmaterial trades.

The third factor which encourages insider trading is the absence of effective sanctions. Under part XIA of the Securities Ordinance, if the Tribunal finds that an individual has engaged in "culpable" insider trading, the only recourse is to publicize that person's culpability.\textsuperscript{75} The purpose of publicly disclosing the Tribunal's finding of culpability is twofold: to cause the inside trader to lose all standing in the business community\textsuperscript{76} and thus to deter future insider trading.\textsuperscript{77} This policy is ineffective for two reasons. First, since the Tribunal has conducted only two inquiries over the past nine years, a person violating the statute can feel secure that there will be little chance of charges being brought. Second, there is no indication that the adverse publicity will cause an individual to lose his or her standing. In the one case in which the Tribunal found directors culpable of insider trading,\textsuperscript{78} the ruling apparently did not affect the violators' community standing.\textsuperscript{79} Ultimately, the purpose of relying on adverse publicity as a sanction will be circumvented where "some might be tempted to take the risk in the belief that bad publicity is a temporary occupational hazard."\textsuperscript{80} Thus, a prospective inside trader in Hong Kong does not face many hurdles.

The Colony's attempts to control insider trading have followed a common pattern: the Securities Commission suggests a strong policy, but then enacts a weak one. This pattern of retreat suggests that the Commission is under great pressure from local investors. Some of this pressure may stem from the number of experienced businesspeople in Hong Kong. Because of the Colony's size, only a few people have busi-

\textsuperscript{74} Id. at 11-12.

\textsuperscript{75} 19 LHK ch. 333, pt. XIA, § 1411(4) (1978).


\textsuperscript{77} See \textit{id}. (citing INST. OF DIRECTORS (LONDON), GUIDELINES FOR DIRECTORS 20).

\textsuperscript{78} See \textit{supra} text accompanying notes 54-57 (discussing the International City Holdings case).


ness expertise. This results in potential "revolving door" conflicts: the individuals responsible for regulating business in Hong Kong may be sympathetic to the interests of former employers, or may want to avoid antagonizing the people with whom they plan to seek employment after leaving government service.

These pressures have led to a regulatory structure that lacks a clear definition of insider trading, a means for detecting violations, and a strong system of deterrence. The next section will review the more effective regulatory system of the United States, which, if tailored to Hong Kong business conditions, could improve the control of insider trading in the Colony.

B. United States

In the nearly fifteen years since the need to control insider trading in Hong Kong was first realized, the Colony has failed to develop a system of either legislative or adjudicative regulation. Future development of the Hong Kong system is likely to be equally inefficient if regulators fail to take notice of the regulatory attempts of other countries with large securities markets. The use of the United States as one such model is appropriate because of its eighty-year history of regulating insider trading through court decisions, statutes, and regulations.

1. Early Developments in the Control of Insider Trading

Under common law a person trading securities had no affirmative duty to disclose information to the other party. The rule of "caveat emptor" dominated; a person had to make the right inquiries before the other party acquired a duty to disclose any knowledge of inside information. Absent an independent duty of disclosure, there could be no liability for trading on inside information.

In 1909, however, the United States Supreme Court found that an affirmative duty of disclosure does exist. In Strong v. Repide, a director of a sugar company tried to purchase the interest of a minority shareholder without telling her the future value of her shares. The Court rescinded the sale of the stock, finding that the director had a duty to disclose the true value of the stock. The Court based its decision on the

81. B.A.K. RIDER & H.L. FRENCH, supra note 4, at 338. The shortage of qualified businesspeople is also the reason for the large number of multidirectorships. Id.
82. D. LANGEVOORT, INSIDER TRADING HANDBOOK 24-25 (1986).
83. 213 U.S. 419 (1909).
84. The value of the company's shares was expected to rise dramatically following its planned sale of property to the Philippine Government. Id. at 425.
“special facts” of the case. This case began the decline of the application of common law principles to securities cases.

Twenty-five years later, Congress passed the Securities Exchange Act of 1934 (1934 Act), which regulates all aspects of securities transactions. The scope of regulation is very broad, partly because of the definition of the word “security” established by the Securities Act of 1933 (1933 Act). In 1948, using the mandate of this section, the SEC en-

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85. The “special facts” relied upon by the Court included the director’s role in the sale of the corporate property and his attempt to hide his identity when purchasing the shares. Id. at 431-32.
87. T.L. HAZEN, THE LAW OF SECURITIES REGULATION 232 (student ed. 1985). The reasons for the enactment of the 1934 Act are broadly stated as follows:

[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal securities holders, to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions. . . .


88. A “security” is defined by section 2(1) of the 1933 Act as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or . . . in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.


89. Section 10(b) makes it unlawful

[i]to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

acted rule 10b-5. Rule 10b-5 prohibits the use, in connection with a securities transaction, of interstate commerce, the mails, or the national securities exchanges as follows:

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. 90

The next section will review the courts’ use of section 10(b) and rule 10b-5 to control the abuse of inside information.

2. Judicial Application of Rule 10b-5

Section 10(b) and rule 10b-5 look very much like general prohibitions of securities fraud. While fraud often occurs in the context of face-to-face transactions, most securities transactions are not face-to-face (or even “quasi-face-to-face,” as in Strong v. Repide 91) since they take place through brokers and exchanges. Thus, after the promulgation of section 10(b) and rule 10b-5, there was some question whether there could be fraud in a failure to disclose inside information while making a purchase or sale when there was no personal contact with the party on the other side of the transaction.

In Cady, Roberts & Co. 92 the SEC found that fraud exists when a person whose “special relationship” to a corporation affords access to inside information breaches a duty not to take unfair advantage of the information by trading the corporation’s securities. The SEC believed that, otherwise, those not in possession of the information would be “exploited.” 93 In SEC v. Texas Gulf Sulphur Co., the United States Court of Appeals for the Second Circuit agreed with this result and held that impersonal transactions are subject to the prohibition against insider trading because of “the justifiable expectation of the securities market place that all investors trading on impersonal exchanges have relatively equal access to material information.” 94

As a result of the language in rule 10b-5 and the Texas Gulf Sulphur decision, the definition of “material information” became very impor-
In *TSC Industries, Inc. v. Northway, Inc.* a proxy dispute case, the Supreme Court decided that information contained in a proxy solicitation is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." This definition has become the standard used in insider trading cases as well; information is material only if a prospective buyer or seller of shares is likely to consider it important in deciding whether to buy, sell, or hold shares.

In *Cady, Roberts* the SEC found that a "special relationship" must exist between a person and a corporation before the person must abstain from trading the corporation's securities. In *Chiarella v. United States* the Supreme Court expanded this rule. Chiarella, an employee of a firm which printed announcements of corporate takeovers for a takeover bidder, purchased the shares of a target company named in those announcements. In reversing Chiarella's conviction for 10(b) and 10b-5 violations, the Court held that "the element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from [Chiarella's] relationship with the sellers of the target company's securities, for [he] had no prior dealings with them." Thus, *Chiarella* established the rule that a person who trades on inside information must also have some relationship with the other parties to the transaction before liability under section 10(b) and rule 10b-5 can exist.

The prosecutor in *Chiarella* proposed an alternative rule: the defendant should be held liable for breaching a duty to the takeover bidder by using information he received through his employers, who were in turn employed by the bidder. Because this so-called "misappropriation" theory was not presented at the trial level, the majority refused to rule on its merits. The Second Circuit, however, has subsequently endorsed this theory.

In *Dirks v. SEC* the Supreme Court decided the circumstances under which a person receiving inside information by way of a "tip"
could be found liable for violations of 10(b) and 10b-5. First, the Court rejected the argument of the SEC that "a tippee 'inherits' the Cady, Roberts obligation to shareholders whenever he receives inside information from an insider . . . ."\(^{105}\) The Court repeated the rule of Chiarella that the duty to disclose information comes from a relationship between the trading parties, "and not merely from one's ability to acquire information because of his position in the market."\(^ {106}\) Instead, the tippee "steps into the insider's shoes" only when there has been a breach of fiduciary duty by the tipper, and the tippee knows or should know that the breach has taken place.\(^ {107}\) Such a breach exists when the tip would result in some personal benefit to the tipper,\(^ {108}\) and the tipper has the intent to deceive or defraud.\(^ {109}\)

In *Ernst & Ernst v. Hochfelder*, the Supreme Court recognized that 10(b) and 10b-5 violations require a certain mental state.\(^ {110}\) The Court based its decision on the language of section 10(b)\(^ {111}\) and a review of the structures of the 1933 and 1934 Acts.\(^ {112}\) Because scienter is a prerequisite to 10(b) and 10b-5 liability, the "Chinese Wall" defense\(^ {113}\) should be available to multiservice financial firms; the department not in possession of the inside information cannot have the requisite intent to misuse the information.\(^ {114}\)

3. Strict Liability for Insider Trading

The preceding section established that a certain mental state must exist before there can be a violation of section 10(b) or rule 10b-5.\(^ {115}\) There are, however, two exceptions to the scienter requirement. The first is a regulation enacted pursuant to section 14(e) of the 1934 Act, which prohibits fraud in connection with tender offers.\(^ {116}\) The regulation, SEC rule 14e-3, places an absolute ban on trading a target company's securi-

\(^{105}\) *Id.* at 655.
\(^{106}\) *Id.* at 657-58 (quoting Chiarella v. United States, 445 U.S. 222, 232-33 n.14 (1980)).
\(^{107}\) *Dirks*, 463 U.S. at 660.
\(^{108}\) *Id.* at 662-64.
\(^{109}\) *See supra* text accompanying notes 89-90.
\(^{111}\) The Court specifically refers to the use of the words " 'manipulative or deceptive' . . . in conjunction with 'device or contrivance.' " *Id.* at 197.
\(^{112}\) The opinion notes that when the drafters of the two acts intended to create liability predicated on negligence, they did so expressly. *Id.* at 200-01.
\(^{113}\) *See generally supra* text accompanying notes 51-52.
\(^{115}\) *See supra* text accompanying notes 107-114.
ties while in possession of material nonpublic information about the tender offer and on giving such information to someone when a trade would be foreseeable.117

The second source of strict liability is section 16(b) of the 1934 Act,118 which allows corporations to recover profits earned from the purchase and sale of its registered securities119 by officers, directors, and ten-percent beneficial shareholders of the corporation within any six-month period. The profits from such transactions are known as "short-swing profits."120

The purpose of section 16(b) is to prevent "the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer... irrespective of any intention on the part of such beneficial owner, director, or officer..."121 The statute not only ignores the intent of the insider, it also ignores whether he or she made use of inside information at all.122 This rule reflects the recognition by Congress of the potential for abuse of inside information and the strong desire of Congress to avoid such abuse. Congress' intent has led the courts to apply a particularly harsh measure of damages for violations of 16(b).123

4. Other Deterrents to Insider Trading

Aside from the statutory prohibitions on insider trading, a number of other deterrents to insider trading exist. For example, the SEC and its predecessors have traditionally employed such remedies as rescission,124 injunctions,125 and disgorgement.126 In addition, there are private rights of action for violations of sections 10(b)127 and 16(b).128

Congress was not satisfied with these remedies. In order to make a

120. T.L. HAZEN, supra note 87, at 413-14.
122. T.L. HAZEN, supra note 87, at 417.
123. See, e.g., Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943), cert. denied, 320 U.S. 751 (1943) (applying a "lowest price in, highest price out" measurement of profits illegally gained within the six-month period).
126. See, e.g., SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983).
stronger statement against the abuse of material, nonpublic information, Congress enacted the Insider Trading Sanctions Act of 1984 as an amendment to the 1934 Act. The Insider Trading Sanctions Act created a new civil penalty for those who trade securities while in possession of material inside information and for those who provide the tips which lead to such trades.

The new civil penalty consists of a fine of up to three times the "profit gained or loss avoided" as a result of the violative transaction. "Profit gained" and "loss avoided" are defined by the Act as "the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information." Essentially, the definition of "profit gained or loss avoided" is a codification of the measure of profits to be disgorged that was applied in SEC v. Mac-Donald. The treble damages provision offers an extra deterrent to insider trading and guarantees that the offender will not retain any "postdissemination" profits.

In addition to creating the new civil penalty, the Insider Trading Sanctions Act also strengthened the existing criminal penalties. While the Act left the five-year maximum prison sentence (per offense) intact, it increased the maximum criminal fine from $10,000 to $100,000 per offense. Thus, insider trading can be quite expensive.

Before the Government can apply the various sanctions, it must discover violations of the securities laws. To accomplish this the United States has developed relatively advanced means of enforcement. When price and volume activity for a certain stock exceeds expected limits, transactions in that stock are "flagged" by stock exchange computers for investigation. Then the SEC looks for signs of insider trading. Such signs include large purchases of small stocks, trades by officers of the issuer, or transactions by several investors bearing the same last name or zip code. With the expansion of the SEC's Electronic Data Gathering,
Analysis, and Retrieval (EDGAR) computer network, such investigations should be facilitated in the future. Furthermore, the SEC has been working to reduce the number of beneficial owners hiding behind nominees. While every illicit transaction cannot be detected, the SEC does notice the major violations.

III. REFORMING THE HONG KONG SYSTEM

Currently, insider trading in Hong Kong goes virtually unchecked. Actually, "local laws and customs almost invite it." Government regulators seem afraid to establish stiff controls on the misuse of inside information. The regulations that do exist are ineffective because they are difficult to enforce and the sanctions which might result from enforcement are not likely to deter violations.

Before the regulation of insider trading can be improved, the Securities Commission must assume a more aggressive posture. Two steps should be taken by the Hong Kong Government to overcome the economic and political pressures on regulators. First, to avoid the pressures of the "revolving door," the Government should encourage the formation of a corps of career securities regulators. Then, to reduce the effect of political pressures in Hong Kong, the Government must find an overriding motivation for change.

In the United States, Congress stated its motivation as follows:

The United States securities markets are liquid, efficient, and fair. The prices of the vast majority of actively traded securities reflect available public information about companies and the economy. Capital formation and our nation's economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets.

138. Bloomenthal, EDGAR Update, 8 SEC. & FED. CORP. L. REP. 113, 113 (1986). The future expansion of computer technology is expected to improve the efficiency of the EDGAR system in much the same manner that word processors improved the efficiency of lawyers. See id. at 115.

139. In order to allow issuers to send proxy statements to as many beneficial owners of shares as possible, intermediaries are forwarding proxies to nonobjecting parties. Bloomenthal, Shareholder Communications—Herein of NOBOs and OBOs, 8 SEC. & FED. CORP. L. REP. 89 (1986); Robinson, How to Solve the Riddle of Beneficial Ownership, in XI SEC '83 at 37-44 (H.S. Schlagman & N.H. Hirsch eds. 1982).

140. Laderman, supra note 137, at 80.


143. See supra text accompanying note 81.
Insider trading threatens these markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules.\textsuperscript{144} By comparison, Hong Kong is only beginning to realize the importance of equal access to securities information. The Deputy Securities Commissioner recently noted that improved disclosure of corporate information would likely attract institutional investors from the United States and Europe.\textsuperscript{145}

The stock listing rules promulgated in Hong Kong during 1986 represent the first step towards broad corporate disclosure. These rules, however, are not comprehensive. One important target of improvements is the use of nominees by beneficial shareholders. In the United States nominees and street names are primarily used by banks, insurance companies, and brokers.\textsuperscript{146} Since those firms are not expected to use nominees to abuse inside information, the desire to "pierce the nominee's veil" is fueled not by a need to enforce securities laws, but by the desire of stock issuers to have the beneficial owners of shares exercise their proxy rights.\textsuperscript{147} Thus, the SEC has been satisfied with discovering the identities of nonobjecting beneficial owners only.\textsuperscript{148}

In Hong Kong the more widespread use (and abuse) of nominees by individual investors\textsuperscript{149} warrants more stringent measures. Neither individual nor institutional investors should be permitted to use nominees unless there is a legitimate and necessary purpose for doing so. Furthermore, to deter the use of offshore nominees Hong Kong should encourage other countries to participate in an exchange of securities market data to facilitate enforcement. Finally, automating the local securities market would simplify an international data exchange and would make local enforcement more simple.

Once regulators are willing to control the market and data is available for the investigation possible abuses, an effective regulatory scheme must be established. Such a scheme must start with a definition of insider trading. In the United States the courts have defined insider trading.\textsuperscript{150} Recently, however, criticism of this willingness to let prosecutors

\textsuperscript{145} Wallace, supra note 28, at 11.
\textsuperscript{146} Robinson, supra note 139, at 43-46.
\textsuperscript{147} Id. at 39-41.
\textsuperscript{148} Id. at 46-48.
\textsuperscript{149} See B.A.K. RIDER & H.L. FFRENCH, supra note 4, at 339.
\textsuperscript{150} Calling Noah Webster, Wall St. J., Mar. 16, 1987, at 26, col. 1.
“make up rules as they go along” has grown.\(^{151}\) As a result, the Senate has begun to investigate the possibility of enacting a statutory definition.\(^{152}\)

Hong Kong already may have found the better approach to defining insider trading. Part XIIA of the Securities Ordinance outlines insider trading in enough detail to allow investors to comply with the regulations, but is also broad enough to permit the courts to close the loopholes that would probably exist if the statute were too precise. The Hong Kong statutory scheme would also permit the development of a body of case law similar to that which has arisen in the United States since the SEC enacted rule 10b-5. This development has not yet taken place, because of the investors’ lack of sophistication and the Securities Commission’s weakness.\(^{153}\)

The Hong Kong definition of insider trading contains one weakness which greatly affects the ability of the Securities Commission and Insider Dealing Tribunal to find that prohibited transactions have taken place—namely, the requirement of wrongful intent.\(^{154}\) One solution to this weakness would be to hold an investor strictly liable for transactions made while the investor was in a position to receive inside information. This suggestion, which in essence would be an expanded version of section 16(b) of the 1934 Act, might be appropriate until the investment climate improved, by which time other regulatory mechanisms could be implemented.

Ultimately, the effectiveness of the regulatory scheme depends on the deterrent effect of the punitive sanctions. In the United States a wide array of sanctions are available, including equitable relief, fines, and prison sentences. The only sanction Hong Kong has applied so far has been the public designation of several directors as culpable inside traders, a designation that has little deterrent effect, if any. The Hong Kong Government must apply stiffer measures to control insider trading effectively.

History suggests that strong regulations can affect the Hong Kong securities market. In 1974, following the meteoric increase in trading on the Hong Kong market, the combined turnover volume of the four Hong Kong stock exchanges dropped by over seventy-five percent.\(^{155}\) The dramatic fall in volume might have resulted from an investor population which tired of endless speculation. The drop in volume, however, also

\(^{151}\) Id. at 26, cols. 1-2; Laderman, supra note 137, at 88, 92.

\(^{152}\) Calling Noah Webster, supra note 150, at 26, col. 2.

\(^{153}\) M.F. HIGGINS, supra note 8, at 149-50.

\(^{154}\) See supra text accompanying notes 42-43.

\(^{155}\) CENSUS & STATISTICS DEP’T, HONG KONG, supra note 3, at 56.
Regulation of Insider Trading in Hong Kong coincided with the enactment of the Securities Ordinance and the Protection of Investors Ordinance. Thus, another explanation for the decline might be that the investing public was afraid that the excesses of the previous four years would not be tolerated under the new regulations. If this explanation is accurate, regulators should take a hardline approach to the treatment of insider trading in Hong Kong.

IV. CONCLUSIONS

Hong Kong has a serious insider trading problem that, if left unchecked, may adversely affect the influx of capital and economic strength of the Colony. This problem appears to stem from the nature of the Hong Kong securities market and from the inability of the Hong Kong Government to legislate effectively against the problem. The existing legislation has failed because of the Government's inability to enforce it on a regular basis and because of the inadequate remedies provided when the current regulations are enforced.

A comparison of the Hong Kong regulatory scheme to that of the United States reveals that the Hong Kong system lacks the investigative facilities and punitive sanctions available to the Securities and Exchange Commission in the United States. Since these factors make the American system more effective, it is recommended that they be implemented in Hong Kong. In this way the Hong Kong Securities Commission can regain control of its markets.