

Research on the Materiality Standard of inside Information

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Abstract

China's legislation on insider trading started relatively late, but it has used comprehensive legislation based on the experience of other jurisdictions, which has a certain advanced nature. The legal norms of our country are relatively vague in defining the materiality standard of inside information. There are two kinds of standards for the determination of the materiality of inside information: how to choose the standard of rational investors and the standard of price sensitivity. Through the analysis of the four legislative methods including definitional, enumerated, precedent and comprehensive from the perspective of comparative law, combined with Chinese existing legal framework and specific national conditions, for the identification standard of inside information, it is suggested to adopt both the price sensitivity standard and the rational investor standard to improve the list of inside information and the legislation in order to make our country's standard for defining the significance of inside information more reasonable.

Keywords

Inside Information, Materiality Criterion, Rational Investor Criterion, Price Sensitivity Criterion

1. Introduction

In order to illegally seek profits in the capital market, securities fraud occurs frequently. Insider trading originates from securities frauds, and has always been one of the most frequent behaviors in securities violations. Although the regulation of insider trading has become the focus of legislation and supervision of securities markets in most countries, there is still a long-term controversy over the views of insider trading in the legislative and theoretical circles of various countries, and a relatively unified definition of insider trading has not been formed.

The academic community generally believes that the definition of insider trading should have the following three basic elements: inside information, insiders and insider trading (Li & Xu, 2017). These three elements and their extension factors also constitute the basic identification standards for the regulation of insider trading in my country. Article 50 of the new Securities Law defines the prohibition of insider trading, that is, “the insider of securities trading inside information and those who illegally obtain inside information are prohibited from using inside information to engage in securities trading activities”. Article 52 (1) of the new Securities Law defines the concept of inside information: “In securities trading activities, information that has not yet been disclosed, involves the issuer’s operations, finances or has a significant impact on the issuer’s securities market price is inside information”. Material means that the information will have a significant impact on the market price of the issuer’s securities. Article 53 (2) of the new Securities Law clearly stipulates that major events in information disclosure meet the materiality criteria and constitute inside information. According to the first paragraph of Article 52 of the new Securities Law, the judgment of inside information shall meet the following criteria: 1) Relevance, 2) Materiality and 3) Non-disclosure, of which the materiality criterion is also the core element for identifying inside information.

Due to the late start and short development time of my country’s securities market, the actual situation and systematization problems in my country were not fully considered when drawing on the relevant regulations of other mature capitalist jurisdictions, resulting in some confusion in application, which also affected Effective crackdown on insider trading. In recent years, the China Securities Regulatory Commission has increased the penalties for insider trading. The new Securities Law has further improved the relevant systems of insider trading on the basis of previous laws, regulations and practices, and greatly increased the cost of illegality. This article will comprehensively analyze the materiality standards of insider information in combination with the new regulations and relevant practices. By reviewing the existing legal norms and practices on the materiality of insider information in my country, it will straighten out the determination of the materiality of insider information at all levels of legal norms. This article is divided into five parts. The first part is the introduction, which introduces the three elements that define insider trading behavior and the three elements that define inside information, focusing on the standard issue of the materiality of inside information. In the second part, through the analysis of the market model of insider trading, the necessity of research on the materiality standard of insider information is obtained. The third part introduces the four international legislative models for the identification of inside information, and analyzes the advantages and problems of comprehensive legislation in my country. The fourth part analyzes the practice in the United States and my country, and focuses on the constituent elements of the standard for determining the materiality of inside information. The fifth part is the conclusion, combined with the analysis of each model, in the comprehensive legislation adopting both

rational investors and price sensitivity standards, trying to make the definition of the significance of inside information in my country more reasonable and more feasible.

2. Necessity of Research on Materiality Standards

Securities market transactions are often full of huge interests and fair transactions are crucial to maintain market stability and balance the interests of transaction subjects. However, as an improper means of competing for interests in the securities market, insider trading affects the stability and development of the securities market seriously. Obviously, insider trading should be strictly regulated. Since the 1990s, the problem of insider trading in securities information has existed for a long time. Although Chinese securities regulatory authorities always attach great importance to the supervision of insider trading in securities information, the laws and regulations of Chinese securities market are still insufficient in the supervision of insider trading in securities, which means that significant standards have not yet been unified. It is generally believed that inside information contains two characteristics: “undisclosed” and “materiality”, and “materiality” are the keys to identifying inside information. The materiality of inside information is one of the necessary criteria for the determination of inside information, and there are serious differences and disputes in the academic circles. The so-called materiality actually refers to the restriction of inside information at the quantitative level, which usually means that once the inside information is disclosed, it may seriously affect the decision-making of investors or the price of securities. It is a necessary measure to rectify and regulate insider trading in the securities market effectively to clarify the definition mode and standard of the materiality of inside information (Cai, 2015). The problem is that my country’s current Securities Law revised in 2019 adopts the definition and specific enumeration method for the determination of inside information behavior. However, there is no clear connotation for the “significant impact”. This has caused the identification of insider trading information in securities practice to become general, vague, and even contradictory. It is impossible to regulate some insider trading behaviors that are not listed in the Securities Law but seriously endanger the securities market. Therefore, in order to strictly regulate the occurrence of insider trading, it is necessary to clearly define the scope of insider information and to explore the standards of insider information in securities transactions and it is important to understand the constituent elements of the criteria. It is an effective measure to rectify and regulate insider trading in the securities market to clarify the definition mode and standard of the materiality of inside information.

Material limitations on the scope of inside information are related to the purpose of prohibiting inside information itself. There are two basic models for prohibiting insider trading: the private interest model and the public interest model. **The private interest model** consists of the fiduciary duty theory and the

theft theory. Under this model, the most fundamental legal basis behind the prohibition of insider trading lies in the protection of private property rights (Xiao, 2017). The property rights of the inside information belong to the company, and the use of relevant information for profit without the company's consent is actually an act of misappropriation of the company's property, which is a breach of fiduciary duty for the insiders of the company, and it also violates the basic principle of protecting property rights for those who have no fiduciary relationship with the company. In fact, not all the information has economic value and property rights protection is not always necessary, so there must be a reasonable scope for inside information. Whether relevant information has economic value depends on market investors' views, whether the information has an important impact on their buying and selling decisions, and ultimately is determined by the actual preferences of actual market investors (Cai, 2015). In contrast, **the public interest model** is mainly based on the parity of information theory, which holds that market participants should ensure information fairness when participating in investment. The information fairness should mainly be based on the preferences of actual investors, because whether it is a private interest model or a public interest model, insider trading regulation is ultimately based on protecting the confidence of market investors, so as to maintain the existing number of investors, encourage more investors to enter the capital market, and maintain the vitality of the market (Xiao, 2017).

To sum up, in the process of supervising the trading of insider information, the core is to determine the securities trading entities have insider trading behaviors. The insider trading information is very important to the determination of insider trading behavior. **The standard judgment of materiality is the core of identifying insider information transactions** and it also plays a decisive role in defining the scope of inside information. Based on the insider trading supervision purpose of protecting market confidence, the criteria for determining the materiality of inside information must have certain factual aspects, and the confidence of actual investors must be protected by taking into account the preferences and characteristics of actual investors in the market (Xie, 2005). It is necessary to prevent insiders from improperly using the inside information that have been obtained improperly, and using the inside information to conduct transactions with the uninformed counterparty, so as to obtain improper benefits and avoid the counterparty's loss. It is necessary to supervise the occurrence of insider trading strictly, so insider information must be clearly defined to prevent insider trading.

3. Legislative Model of Insider Trading Information

Jurisdictions have adopted **four different models** for the legal definition of inside information. **One is a definitional approach**, (Xiao, 2014) such as EU legislation—Article 1 of the Market Abuse Directive 2003 states: “Insider information means any accurate, not yet public information, which relates directly or

indirectly to the issuers of one or more financial instruments or one or more financial instruments. If this information is public, it may have a significant impact on the price of financial instruments or the price of related financial derivatives". The determination of inside information is not a simple task, and its content is very extensive. Legislation cannot fully enumerate and exhaust all inside information. Securities trading is changing with each passing day, and with the development of society, securities insider trading will also be very different. Not to mention that the specific enumeration of cases has the risk of becoming obsolete. Some emerging insider trading information may not be covered by the specific enumeration method. Therefore, the method of definition can meet the needs of the development of securities law, but the ambiguity of the definition cannot completely solve the dispute, which may lead to related disputes. **The second is to use the method of enumeration**, such as the Japanese legislation: it makes an enumeration in Article 166 of the Financial Instruments and Exchange Act of 2006 (Xiao, 2014). It states that 1) The decision-making authority for the execution of business of the listed company, etc. decides to execute the following matters, or the authority decides not to execute matters related to the decision (limited to those that have already been disclosed); subscribe to a joint-stock company specified in Article 199, Paragraph 1 of the Company Act Issued shares, etc.; reduction of capital amount; reduction of capital reserve or profit reserve; gratuitous distribution, division, exchange, transfer of shares; merger and division of companies; assignment or acceptance of all or part of a business; Dissolution (except due to mergers); Enterpriseization of new products or technologies, etc. 2) The listed company has the following facts: damages caused by disasters or in the course of business; abnormal changes in major shareholders; facts that cause the listing of a particular security or an option relating to a particular security to be revoked or the registration was cancelled; similar to those listed above and prescribed by decree. 3) Comparing the sales, ordinary profit or net profit of the listed company, etc., the distribution specified in No. 1, or the sales of the enterprise group to which the listed company belongs, and the most recent expected value disclosed (if there is no expected value, it is the actual performance value of the previous business year disclosed), there is a difference in the latest expected value calculated by the listed company, etc. or the final account of the business year (limited to have a significant impact on investors' investment judgments and comply with the specified standards of the orders). 4) In addition to the facts listed in the previous three, other important facts related to the operation, business or property of the listed company, etc., and have a significant impact on investors' investment judgments." Although the Japanese legislation adopts the method of enumeration, in addition to the facts listed in the first three items, other items are regarded as a kind of bottom line to determine the significance, which can achieve the corresponding prevention of specific enumeration methods. **The third is to adopt the method of definition and enumeration**, such as the legislation of Taiwan region of our

country (Xiao, 2014). Item 4 of Article 157-1 of the Securities and Exchange Act of Taiwan defines inside information as information referring to the company's finance, business, market supply and demand of the securities or public acquisition, which has a significant impact on its stock price or the investment decision of legitimate investors. And regulations on related matters such as its scope and disclosure method shall be prescribed by the competent authority. In December 2010, Taiwan Securities Regulatory Commission promulgated the "Major Information Management Measures". The Regulations listed the inside information matters from three aspects, which involved the company's finance and business, the market supply and demand of the securities, and the news that the company had a significant impact on its ability to pay principal and interest. **The fourth is the use of case law such as the United States** (Xiao, 2014). In the United States, the legal rules for determining inside information were gradually established and developed through the judgment of a series of cases such as SEC V. Texas Gulf Sulphur Co. (1968), TSC Industries Inc. V. Northway Inc. (1976), United States V. Carpenter (1986) and Basic V. Levinson (1988). There are two standards for judging the materiality of securities insider trading information in US legislation: One is the "rational investor standard", which is from the perspective of a rational investor, emphasizing the subjective influence of a rational investor in securities insider trading information. The second is the "price sensitivity criterion", which focuses on the objective impact of securities insider information on securities prices.

Article 52 of Chinese current **Securities Law** revised in 2019 adopts the definition and specific enumeration method for the determination of inside information behavior. In my country, the Securities Law is a commercial law. At present, my country's legislation on insider information behavior in the securities market is mainly stipulated in the Securities Law and related regulations. **The relevant supporting laws and regulations** are mainly that the law promulgated and implemented by the National People's Congress in 1998: **Securities Law** (revised in 2019, currently effective); administrative regulations promulgated and implemented by the State Council in 1993: **Interim Regulations on the Administration of Stock Issuance and Trading**; departmental regulations issued by the China Securities Regulatory Commission in 2007: **Guidelines for the Determination of Insider Trading Behaviors in the Securities Market; Regulations on the Establishment of a Registration and Management System for Insiders of Insider Information by Listed Companies** issued on October 25, 2011, (Zhang, 2014) and the judicial interpretation jointly issued by Supreme Judiciary in 2012: Interpretation of the Supreme People's Court and the Supreme People's Procuratorate on **Several Issues Concerning the Specific Application of Law in Handling Criminal Cases of Insider Trading and Disclosure of Inside Information** (Yang, 2014).

Chinese legislation on insider trading started relatively late, but it has adopted comprehensive legislation based on the experience of other jurisdictions, which

has a certain advanced nature. However, the ideas of the legislators are not clear and clear, and the logical rigor of the legal system is also lacking because my country does not have a solid foundation for the development of the capital market. Therefore, after a period of development, some problems have arisen. What needs to be done now is to straighten out the legal norms for the determination of the materiality of inside information, and to clarify its ambiguity and contradictions without undermining the general framework of the original legislation.

4. Elements of the Materiality Determination Standard

Since the promulgation of the Securities Act of 1933, the scope of information disclosure obligations set by the US securities laws and regulations has basically been based on the “materiality” standard. Determining whether it meets the “materiality” standard can be divided into principles and rules, which have been established in the judicial practice of the United States over the years. The most representative case is the case of **TSC Industries, Inc. v. Northway, Inc.** The US Supreme Court has basically established the principled standard for determining “materiality”. The issue involved in this case is how to judge whether the information meets the “materiality” standard in the voting rights solicitation process (Zhang, 2009). The Supreme Court justice pointed out that **when there is sufficient factual basis and possibility to show that the empirical investor believes that the information is important for decision-making, or when the information can change the existing information state, then the obligor is obliged to disclose it because it satisfies the “materiality” objective criteria.**

The US Securities and Exchange Commission (SEC), as the regulator of the securities market, has incentives to provide market participants with stable expectations, and should propose regulatory standards for judging “materiality” from the perspectives of principled norms and regulatory norms (Li & Li, 2020). **On the one hand, SEC endorses the US Supreme Court’s principled norm on “materiality” basically, stating that information meets the “materiality” criterion if there is a sufficient probability that a reasonable investor would consider the information to be material to the purchase or sale of the registered securities. On the other hand, although it admits that it cannot provide regulatory norms for judging “materiality”, it has also formulated some specific rules and guidelines in order to provide market entities with a compliance basis.** Firstly, SEC identifies what areas of information may meet the “materiality” criteria in the way of enumeration. For example, in discussing whether information related to the Regulation Fair Disclosure meets the “materiality” criteria, SEC lists information in areas such as revenue, mergers and acquisitions, new products, management changes, audit firm changes, other outstanding securities, and bankruptcy, noting that information in these areas may meet the “materiality” standard. Secondly, SEC refuses to give a clear judgment ratio to reduce the risk of obligors evading regulatory requirements through strategic behavior.

The materiality of insider trading information is one of the necessary criteria for the determination of insider information, and there are serious differences and disputes in academia. The so-called materiality actually refers to the restriction of inside information at the quantitative level, which usually means that once the inside information is disclosed, it may seriously affect the decision-making of investors or the price of securities. It is a necessary measure to effectively rectify and regulate insider trading in the securities market to clarify the definition mode and standard of the materiality of inside information (Xu, 2017). **The domestic consensus is that inside information contains two characteristics: undisclosed and significant**, and “significant” is the key to identify inside information (Peng, 2010; Wen, 2015; Xiao, 2012; Zhang & Zhang, 2010; Zhang, 2014). The problem is that my country’s current Securities Law revised in 2019 adopts the definition and specific enumeration method for the determination of inside information behavior. However, there is no clear connotation for the “significant impact”, which caused the identification of insider trading information in securities practice become general, vague, and even contradictory. As a result, it is impossible to regulate some insider trading behaviors that are not listed in the “Securities Law” but seriously endanger the securities market. Therefore, in order to explore the inside information standard of securities trading, it is necessary to understand the constituent elements of its judgment standard, which sparks some debate in academia. And **there are different arguments on its theory**. Ye Lin believes that the characteristics of inside information are as follows: **the first is price**, which only refers to price fluctuation information; **the second is enterprise**, which is limited to companies or enterprises; **the third is undisclosed; the fourth is materiality**. Chen Su believes that inside information should be **price sensitive and undisclosed**, and price sensitivity can be divided into relevance and materiality (Yang, 2014). In essence, new Securities Law of China adopts a legislative approach that combines general provisions with the same enumeration method, and the criteria for judging the materiality of securities insider information can also be comprehensively judged from two different viewpoints. One is the “**price sensitivity standard**” and the “**rational investor standard**”, and the former emphasizes that the judgment of the significance of securities insider trading information needs to have a significant impact on the price of the securities market (Wang, 2021; Peng, 2007; Fan & Wang, 2007; Ye, 2013; Zhu, 2011). The latter emphasizes that the judgment of the materiality of securities insider trading information needs to pay attention to the fact that insider information may have an important impact on the decision-making of rational investors (Xie, 2013; Li & Dong, 2009). According to the general provisions made in Article 52 (1) of the Securities Law, inside information refers to unpublished information that involves a company’s operations, finances, or has a significant impact on the market price of the company’s securities. The standard for determining the significance of insider information in China is undoubtedly the expression of the price sensitivity standard rather than

the rational investor standard. From the practice of the CSRC, its judgment on the materiality of insider trading is mainly based on the judgment standard of possible price sensitivity, and the actual price sensitivity standard is not an independent criterion for materiality. In addition, judging from the enumeration of Article 80 (2) and Article 81 (2) of the Securities Law, the information with possible price sensitivity is related to the company's operation, finance, and owner's equity. Such information is determined to be inside information, which implies the setting of rational investors. Furthermore, the determination of inside information does not refer to the inevitable occurrence of the event to which the information refers, but to the reasonable expectation or reasonable possibility of occurrence. Therefore, it is not necessary to prove whether the event actually occurred, as long as it is necessary to prove that the event information itself exists objectively. It meets the general judgment standard of materiality. The determination of the timing of the formation of inside information does not necessarily require that the information has reached a level that is basically certain, and the factors affecting the formation of inside information may have a significant impact on the market price of the company's securities. The clarity of inside information is different from the final certainty of information. An important factor in judgment is whether it is clear for rational investors to make decisions (Xiao, 2017).

5. Conclusion

With the rapid development of modern society, the endless technological innovations in the Internet era have made insider trading more hidden and technical, and new insider trading contents and methods have also followed, which increases the difficulty of combating insider trading objectively. However, it remains the same and many difficult issues are attributed to what is inside information and what is the fundamental issue of the significance of inside information. After reviewing the materiality standards of insider information of China, we find that although China adopts comprehensive legislation, due to it starts late, there is a lack of forward-looking systematic planning when drawing on advanced legislative experience in the early development process. The main problems are the inconsistency of legal definitions among different laws in legislation and the inconsistency of legal application standards, as well as the lack of scientificity in enumerating matters. **Combined with the analysis of each model, the comprehensive legislation adopts the criteria of rational investors and price sensitivity, clarifying the "possible" price impact, and improving the enumeration of matters, so as to make the definition of the significance of inside information more reasonable and feasible.** With the rapid development of the securities market, only the joint efforts of all walks of life can better prevent insider information trading and promote the stable development of the securities market. At the same time, by judging the significance of inside information, we can clarify the scope of inside information, urge relevant trans-

action entities to perform corresponding legal obligations, maintain the stability of the securities market, and protect relevant competition.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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