

## Insider Trading – A Comparative Perspective

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The United States Securities law framework may be perceived as a model to be adapted to the culture and needs of other jurisdictions.<sup>1</sup> Included within this framework are issues focusing on insider trading practices. Examining U.S. law on this subject, however, reveals a regime that at times fails to accord fair treatment to market participants and impedes commercial certainty.<sup>2</sup> Countries abroad thus may be ill served by embracing the U.S. model in this area. Indeed, with respect to insider trading regulation, a survey of the securities laws of developed markets reveals that these countries have rejected the U.S. approach.<sup>3</sup> By adhering to an insider trading prescription premised on participant equal access to material nonpublic information,<sup>4</sup> a number of these countries reflect the U.S. law in the pre-*Chiarella*<sup>5</sup> era.<sup>6</sup>

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<sup>1</sup> See generally M. Steinberg, *International Securities Law – A Contemporary and Comparative Analysis* (1999).

<sup>2</sup> See *infra* notes 58-77 and accompanying text.

<sup>3</sup> See *infra* notes 84-136 and accompanying text.

<sup>4</sup> See *infra* notes 120-127 and accompanying text.

<sup>5</sup> *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>6</sup> See *infra* notes 21-27 and accompanying text.

Given the ambiguity and complexity of U.S. law in the insider trading area, the Congress and the Securities and Exchange Commission (SEC) may be advised to assess the regulatory framework in certain other countries and determine their feasibility of application to the U.S. system. It may eventuate that key principles readily can be implemented from favored securities jurisdictions in order to enhance the clarity and efficiency of the U.S. framework.<sup>7</sup>

Regardless of its purported shortcomings, the U.S. securities regime maintains a critical component that other countries thus far have failed to achieve: an enforcement framework, based on government as well as private actions, that enhances compliance with the law and facilitates the levying of sanctions should violations occur.<sup>8</sup> Effective enforcement is the key attribute of the U.S. securities law framework that distinguishes it from the regulatory structure existing in other countries. Hence, although the contours of U.S. securities law in the insider trading area may need refinement, effective enforcement elevates the U.S. framework to preeminence among securities markets. Briefly put, it is far more beneficial for achieving market integrity and investor confidence to effectively implement imperfect (yet palatable) securities laws than have admirable statutes that are rarely or episodically enforced.<sup>9</sup>

This paper thus focuses on regulation of insider trading regulation in developed securities markets. First, the U.S. regime is discussed. Thereafter, the securities laws of selected developed markets are addressed in order to provide contrasts to the U.S. approach. Last, the paper focuses on a number of significant issues that merit exploration.

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<sup>7</sup> See, e.g., *infra* notes 84-136 and accompanying text.

<sup>8</sup> See *infra* notes 149-158 and accompanying text.

<sup>9</sup> See *infra* note 149-161 and accompanying text.

## I. U.S. REGULATION OF INSIDER TRADING

### A. Preeminence of Federal Law

The following discussion examines key aspects of U.S. law in the insider trading area. With respect to insider trading regulation, federal law is the primary source of regulation.<sup>10</sup> Although some states, such as New York, allow derivative suits against inside traders based on unjust enrichment<sup>11</sup> and perceived injury to the corporate enterprise,<sup>12</sup> state law often is unavailable in this context.<sup>13</sup> For example, the nonrecognition by state courts of an insider's disclosure obligation when transactions occur on impersonal securities markets<sup>14</sup> as well as such courts' refusal to find the requisite injury to the corporation<sup>15</sup> signify that allegedly aggrieved traders must turn to federal law to seek redress.<sup>16</sup>

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<sup>10</sup> See generally W. Wang & M. Steinberg, *Insider Trading* (1996 & 2002 supp.)

<sup>11</sup> See, e.g., *Diamond v. Oreanumo*, 24 N.Y.2d 494, 498-499, 248 N.E.2d, 910, 912, 301 N.Y.S.2d 78, 81 (1969).

<sup>12</sup> *Id.* at 500-503, 248 N.E.2d at 913-915, 301 N.Y.S.2d at 82-85.

<sup>13</sup> See, e.g., *Freeman v. Decio*, 584 F.2d 186, 187-196 (7<sup>th</sup> Cir. 1978) (applying Indiana law); *Schein v. Chasen*, 313 So.2d 739, 746 (Fla. 1975); W. Wang & M. Steinberg, *supra* note 10, § 16.1, at 1106 ("State law is rarely applied to stock market insider trading.").

<sup>14</sup> See, e.g., *Van Shaack Holdings, Ltd. v. Van Shaack*, 867 P.2d 892 (Colo. 1994); *Bailey v. Vaughan*, 178 W.Va. 371, 359 N.E.2d 599 (1987); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932).

<sup>15</sup> Sources cited note 14 *supra*. See Branson, *Choosing the Appropriate Default Rule – Insider Trading Under State Law*, 45 Ala. L. Rev. 753 (1994); Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 Wash. & Lee L. Rev. 845 (1982).

<sup>16</sup> Steinberg, *supra* note 1, at 106-107. Note that certain state securities laws may allow government and/or private actions based on alleged insider trading violations. See W. Wang & M. Steinberg, *supra* note 10, at § 16.4. See generally M. Steinberg & R. Ferrara, *Securities Practice: Federal and State Enforcement* §§ 12:01-12:29 (2d ed. 2001).

Section 16 of the Securities Exchange Act of 1934<sup>17</sup> governs “short-swing” trading by directors, officers, and ten percent equity holders of publicly-held entities. Pursuant to Section 16(b), such persons are subject to strict liability, requiring disgorgement of all profit, if they buy and sell (or sell and buy) an equity security of a subject entity within a six-month period.<sup>18</sup> Section 16 raises several complex issues,<sup>19</sup> including whether the statute has outlived its usefulness and should be repealed.<sup>20</sup> This paper declines to enter the Section 16 fray, focusing instead on the securities acts’ antifraud provisions, which constitute the essence of insider trading regulation in the United States.

## **B. Rejection of Access and Parity Theories**

Under U. S. Law, no statute codifies the contours of the insider trading prohibition. Rather, the federal courts and the SEC are the principal actors. Prior to U.S. Supreme Court decisions in the 1980s, lower courts

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<sup>17</sup> 15 U.S.C. § 78p.

<sup>18</sup> See, e.g., *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9<sup>th</sup> Cir. 1981); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943). See generally P. Romeo & A. Dye, *Section 16 Reporting Guide* (2001).

<sup>19</sup> For example, these issues include the concepts of beneficial ownership and attribution, identifying which persons may be officers, and applying the objective versus the pragmatic approach. See, e.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *CBI Industries, Inc., v. Horton*, 682 F.2d 643 (7<sup>th</sup> Cir. 1982); *Merrill Lynch, Pierce, Fenner and Smith v. Livingston*, 566 F.2d 1119 (9<sup>th</sup> Cir. 1978); Securities Exchange Act Release No. 25234, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709 SEC 1991).

<sup>20</sup> See O’Conner, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 Fordham L. Rev. 309 (1989). But see Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L.J. 391 (1991). See generally Steinberg & Lansdale, *The Judicial and Regulatory Constriction of Section 16(b) of the Securities Exchange Act of 1934*, 68 Notre Dame L. Rev. 33 (1992).

adhered to the parity of information<sup>21</sup> and equal access approaches<sup>22</sup> when interpreting the “disclose or abstain” mandate of Securities Exchange Act Section 10(b)<sup>23</sup> (and SEC Rule 10b-5<sup>24</sup>) in the insider trading setting. Under the parity of information theory, as enunciated by the U.S. Court of Appeals for the Second Circuit, “anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed.”<sup>25</sup> The equal access theory, a more narrow approach, posits that “[a]nyone – corporate insider or not – who regularly receives material nonpublic information may not use this information to trade in securities without incurring an affirmative duty to disclose.”<sup>26</sup> Insofar as tipper-tippee liability, lower courts held that a tippee stood in the shoes of the tipper. A tippee knowingly receiving material nonpublic information from a tipper, when such tipper could not trade on that information, likewise was subject to the disclose or abstain mandate.<sup>27</sup> As will be discussed in the paper’s next section, a number of countries by statute adhere to at least some of the foregoing principles.<sup>28</sup>

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<sup>21</sup> See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc); *infra* note 25 and accompanying text.

<sup>22</sup> See, e.g., *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev’d*, 445 U.S. 222 (1980); *infra* note 26 and accompanying text.

<sup>23</sup> 15 U.S.C. § 78j(b).

<sup>24</sup> 17 C.F.R. § 240.10b-5. See generally Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. Pa. L. Rev. 263 (1980).

<sup>25</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc).

<sup>26</sup> *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev’d*, 445 U.S. 222 (1980).

<sup>27</sup> See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

<sup>28</sup> See *infra* notes 120-136 and accompanying text.

Today, the parity of information and equal access approaches for Section 10(b) purposes no longer retain validity.<sup>29</sup> Rather, as construed by the U.S. Supreme Court, the breadth of the insider trading proscription under Section 10(b) is premised on principles based on fiduciary duty and trust and confidence.<sup>30</sup> Other key concepts in this context include the materiality<sup>31</sup> of the particular information and whether that information is confidential (namely, whether it has been adequately disseminated and absorbed by the investment community).<sup>32</sup>

Hence, as interpreted by the U.S. Supreme Court, trading on the basis of material nonpublic information by a director, officer, or other insider (e.g., a controlling shareholder) in the subject company's securities is prohibited under Section 10(b) because, by engaging in such trading, such person breaches a fiduciary duty owed to the company and to the parties on the opposite side of the transaction(s), namely, the company's shareholders.<sup>33</sup> Accordingly, a disclosure obligation arises in this context from a relationship of trust and

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<sup>29</sup> See, e.g., *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>30</sup> See e.g., *Chiarella*, 445 U.S. at 230 (opining that such liability “is premised upon a duty to disclose arising from a relationship of trust and confidence”).

<sup>31</sup> See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 232, 240 n. 18 (1988); *Ganino v. Citizens Utilities Company*, 228 F.3d 154 (2d Cir. 2000); *SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997).

<sup>32</sup> See, e.g., *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993); *In re Faberge, Inc.*, 45 S.E.C. 244, 256 (1973); Steinberg, *supra* note 1, at 109-110. From a general perspective:

[M]aterial information becomes public in either of two ways. The first view is that information that is disseminated and absorbed by the investment community is public. The second view is premised on the efficient market theory, and under this view, information is deemed public when the active investment community is aware of such information. Under the efficient market theory, information that is known by the investment community will be reflected in the price of an efficiently traded security.

M. Steinberg, *Securities Regulation: Liabilities and Remedies* § 3.03 (2001).

<sup>33</sup> See, e.g., *Chiarella*, 445 U.S. at 230.

confidence between the transacting participants.<sup>34</sup> Likewise, the subject company's consultants, including lawyers, accountants, and bankers, who become privy to material nonpublic information with the understanding that this information must remain confidential, are defined as quasi-insiders and thereby are deemed to have a relationship of trust and confidence with the company and its shareholders.<sup>35</sup> Such persons accordingly are subject to the disclose or abstain mandate, to wit, that they must adequately disclose the material information to the marketplace or abstain from trading (as well as tipping) until such dissemination is effected.<sup>36</sup> Nonetheless, insiders, who elect to make adequate disclosure prior to their trade(s) (or tip(s)), violate the corporation's need for confidentiality regarding such information and incur state law liability exposure.<sup>37</sup>

In regard to "outsiders," namely, those individuals who do not have a fiduciary obligation to those who trade on the other side of the subject transaction(s), the misappropriation theory may be invoked.<sup>38</sup> Under this theory, a Section 10(b) violation occurs when the subject actor misappropriates material nonpublic information for securities trading objectives, resulting in breaching a relationship of trust and confidence to the source of the information, irrespective whether such source is or is not a party to the trade.<sup>39</sup> Accordingly, an employee who misappropriates material confidential information entrusted to her employer and who uses such information for

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<sup>34</sup> *Id.*

<sup>35</sup> *Dirks*, 463 U.S. 646, 655 n. 14 (1983).

<sup>36</sup> *Id.* ("The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.").

<sup>37</sup> See Steinberg, *supra* note 1, at 110-111; W. Wang & M. Steinberg, *supra* note 10, at § 5.2.

<sup>38</sup> See, e.g., *United States v. O'Hagan* 117 S.Ct. 2199 (1997).

<sup>39</sup> *Id.* at 2207. See *United States v. Falcone*, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,489 (2d Cir. 2001).

securities trading purposes breaches a relationship of trust and confidence to her employer and perhaps to her employer's clients.<sup>40</sup>

Turning to unlawful "tipping" under Section 10(b), the critical inquiries are whether the tipper breached his fiduciary duty (or a relationship of trust and confidence) by communicating the subject information to his tippee(s) and whether the subject tippee(s) knew or should have known of the breach.<sup>41</sup> Without the finding of a breach, a tippee may trade and tip without violating Section 10(b).<sup>42</sup> Consistent with Supreme Court analysis, an insider is held to breach his fiduciary duty by tipping the subject information when having the motivation to receive a personal benefit. Such personal benefit normally is of a pecuniary nature, such as cash or elevation in status that will result in future financial benefits.<sup>43</sup> A gift also is deemed a sufficient personal benefit: The gift of tipping the material nonpublic information is likened to trading by the insider himself with the transfer to the tippee-recipient of the profits generated from the trades.<sup>44</sup>

### C. Rule 14e-3 – Insider Trading in the Tender Offer Setting

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<sup>40</sup> 117 S. Ct. at 2207. See *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); Steinberg, *supra* note 1, at 111. See generally W. Wang & M. Steinberg, *supra* note 10, at § 5.4 (2001 supp.); Bromberg & Lowenfels, *Misappropriation in the Supreme Court*, 31 Rev. Sec. & Comm. Reg. 37 (1998); Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 Ohio St. L. J. 1223 (1998); Ramirez & Gilbert, *The Misappropriation Theory of Insider Trading Under United States v. O'Hagan: Why Its Bark Is Worse Than Its Bite*, 26 Sec. Reg. L.J. 162 (1998); Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. Corp. L. 395 (1998).

<sup>41</sup> *Dirks v. SEC*, 463 U.S. 646 (1983).

<sup>42</sup> *Id.* at 662.

<sup>43</sup> *Id.* at 662-664.

<sup>44</sup> *Id.* at 664 (opining that "[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient"); Steinberg, *supra* note 1, at 111. See Hiler, *Dirks v. SEC – A Study in Cause and Effect*, 43 Md. L. Rev. 292 (1984).

In contrast to the Section 10(b) jurisprudence of insider trading is SEC Rule 14e-3 which applies only in the tender offer setting.<sup>45</sup> In this limited context, the proscriptions against trading and tipping on material confidential information are significantly broader. Under Rule 14e-3, a person who obtains material confidential information regarding a tender offer directly or indirectly from the offeror (bidder), target corporation, or an intermediary neither can trade nor tip prior to adequate public disclosure (and absorption) of such information.<sup>46</sup> In addition, a tippee of material confidential information relating to a tender offer who knows or should know that the subject information comes directly or indirectly from an offeror, target corporation or intermediary similarly cannot trade or tip prior to adequate public disclosure (and absorption) of this information.<sup>47</sup> Rule 14e-3 provides an exception to this expansive disclose or abstain rule for multi-service financial institutions that adopt and implement sufficient screening mechanisms that effectively prevent the flow of confidential information to those who effect or recommend trades in the subject company's securities.<sup>48</sup>

#### **D. Critique of U.S. Insider Trading Law**

U.S. law on insider trading is far from laudable. Today, as a result of Supreme Court decisions, concepts focusing on fiduciary duty, misappropriation, and financial benefit determine the propriety of transactions

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<sup>45</sup> 17 C.F.R. § 240.14e-3. Rule 14e-3 was adopted in Securities Exchange Act Release No. 17120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (1980).

<sup>46</sup> See Rule 14e-3(a), (d), 17 C.F.R. § 240.14e-3(a), (d). The Supreme Court upheld Rule 14e-3's validity in *United States v. O'Hagan*, 117 S.Ct. 2199 (1997).

<sup>47</sup> Rule 14e-3(d), 17 C.F.R. § 240.14e-3(d).

<sup>48</sup> Rule 14e-3(b); M. Steinberg, *supra* note 1, at 112. See SEC Division of Market Regulation, "Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information," [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,520 (1990); Levine, Gardiner & Swanson, *Multiservice Securities Firms: Coping With Conflicts in a Tender Offer Context*, 23 Wake Forest L. Rev. 41 (1988); Steinberg & Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. Rev. 1783 (1994).

consummated or contemplated. The objective of ensuring that ordinary investors are on an equal footing with market professionals to access material nonpublic information is no longer viable under Section 10(b) insider trading jurisprudence.<sup>49</sup> Although Congress clearly intended the federal securities acts to extend greater investor protection than state law, the Supreme Court's foremost reliance on state law premised on concepts of fiduciary duty slights that congressional objective.<sup>50</sup>

Indeed, the SEC, acting ostensibly within its rulemaking authority, has sought to minimize restrictive Supreme Court law. One example is the SEC's promulgation of Rule 14e-3 which sets forth expansive parity of information and anti-tipping mandates in the tender offer context.<sup>51</sup> In the Section 10(b) setting, the Commission has advocated a broad construction of Supreme Court precedent,<sup>52</sup> even prescribing new rules that

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<sup>49</sup> See *supra* notes 21-44 and accompanying text.

<sup>50</sup> See *Chiarella*, 445 U.S. at 245-252. (Blackmun, J., dissenting). As Justice Blackmun opined:

“By its narrow construction of § 10(b) and Rule 10b-5, the Court places the federal securities laws in the rearguard of this movement, a position opposite to the expectations of Congress at the time the securities laws were enacted . . . . I cannot agree that the statute and Rule are so limited. The Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate. As Congress itself has recognized, it is integral to this purpose to assure that dealing in securities is fair and without undue preferences or advantages among investors.”

*Id.* at 248. See also, Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 Hofstra L. Rev. 341 (1982); Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 Wash. & Lee L. Rev. 1189 (1995).

<sup>51</sup> See *supra* notes 45-48 and accompanying text.

<sup>52</sup> Two such examples are the SEC's assertion that applicable Supreme Court decisions allow for broad interpretations of trading “on the basis of” inside information and the requisite “benefit” for tipping purposes. See, e.g., *SEC v. Adler*, 137 F.3d 1325 (11<sup>th</sup> Cir. 1998) (rejecting SEC's assertion but adopting a presumption of use when one trades while knowingly possessing material nonpublic information); *SEC v. Stevens*, SEC Litigation

in effect “overturn” lower court authority.<sup>53</sup> In another recent regulatory action, the SEC adopted Regulation FD that seeks to terminate the practice by companies of selectively disclosing material nonpublic information to market professionals and favored shareholders.<sup>54</sup> While these selective disclosure practices constitute illegal insider tipping under the laws of many countries<sup>55</sup> and indeed were illegal in this country prior to the Supreme Court’s decision in *Dirks*,<sup>56</sup> such conduct is impermissible under Section 10(b) today only if the tipper is motivated by a desire to benefit personally from the selective disclosure.<sup>57</sup>

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Release No. 12813 (March 19, 1991) (settlement where SEC alleged that insider received personal benefit under *Dirks* test by “tipping” inside information to securities analysts).

<sup>53</sup> See SEC Rules 10b5-1, 10b5-2, 17 C.F.R. § 240.10b5-1, 10b5-2, adopted in, Securities Exchange Act Release No. 43154, [2000 Transfer Binder] Fed. Sec. L. Rep.(CCH) ¶ 86,319 (2000). By adopting in Rule 10b5-1 a broad “awareness” test rather than a “use” standard for determining when trading is “on the basis” of material nonpublic information, the SEC rejected the standards set forth in at least two appellate court decisions. See *United States v. Smith*, 55 F.3d 1051 (9<sup>th</sup> Cir. 1998); *SEC v. Adler*, 37 F.3d 1325 (11<sup>th</sup> Cir. 1998); Horowitz & Bitar, *Insider Trading: New SEC Rules and an Important New Case*, 28 Sec. Reg. L.J. 364 (2000); Nagy, *The “Possession Vs. Use” Debate in the Context of Securities Trading By Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. Cin. L. Rev. 1129 (1999); Sinai, *Rumors, Possession v. Use, Fiduciary Duty and Other Current Insider Trading Considerations*, 55 Bus. Law. 743 (2000). Moreover, by its promulgation of Rule 10b5-2, the SEC has “overturned” the Second Circuit’s decision in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (discussed *infra* notes 66-77 and accompanying text).

<sup>54</sup> See Securities Exchange Act Release No. 43154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319 (2000).

<sup>55</sup> See *infra* notes 131-136 and accompanying text.

<sup>56</sup> See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *supra* note 27 and accompanying text.

<sup>57</sup> See *supra* notes 41-44 and accompanying text.

Some concrete examples illustrate the erratic treatment of insider trading law in the United States. One striking illustration is the different treatment accorded to tender offers due to SEC Rule 14e-3.<sup>58</sup> Literally, an individual can legally retain profits by trading on material inside information or be held liable simply by the fortuity of whether a tender offer is implicated. For example, Barry Switzer, the former football coach of the Dallas Cowboys and the University of Oklahoma, inadvertently received material nonpublic information from a key corporate executive relating to a forthcoming merger transaction.<sup>59</sup> Knowing the information to be reliable because of his relationship with the insider, Switzer (along with his cronies) traded on the basis of this information and made a handsome profit.<sup>60</sup> In that the insider was unaware of Switzer being privy to the communications at issue, the court held there was no unlawful tipping.<sup>61</sup> Because the tippee's liability under Section 10(b) is derivative in nature,<sup>62</sup> the finding that the insider-tipper did not breach his fiduciary duty signified that Switzer as the tippee traded lawfully, and, hence, was entitled to keep his profits.<sup>63</sup>

The result in *Switzer* would have been entirely different if the subject transaction had been structured as a tender offer rather than a merger. In that event, Rule 14e-3 as well as Section 10(b) would have applied. Although Switzer would have avoided liability under Section 10(b), he would have violated Rule 14e-3 by trading on material nonpublic information that he knew derived from a reliable inside source.<sup>64</sup> Hence, pursuant

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<sup>58</sup> For a description of Rule 14e-3, see *supra* notes 45-48 and accompanying text.

<sup>59</sup> *SEC v. Switzer*, 590 F. Supp. 756, 758, 762 (W.D. Okla. 1984).

<sup>60</sup> *Id.* at 762-764.

<sup>61</sup> *Id.* at 758, 766.

<sup>62</sup> *Dirks*, 463 U.S. at 660-664. See *supra* notes 41-44 and accompanying text.

<sup>63</sup> *Switzer*, 590 F. Supp. at 764-766.

<sup>64</sup> See Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a).

to Rule 14e-3, irrespective of the tipper's liability, a tippee incurs liability by knowingly trading on material inside information that directly or indirectly derives from a subject corporation.<sup>65</sup> Thus, Switzer's avoidance of liability and lawful retention of significant profits were owed to the manner in which the affected transaction was structured.

This inconsistency becomes more poignant when the *Chestman*<sup>66</sup> scenario, involving a criminal prosecution, is considered. There, the Second Circuit en banc held that Chestman was not liable under Section 10(b) because his tipper breached no fiduciary duty by conveying material inside information relating to a forthcoming tender offer.<sup>67</sup> Nonetheless, Chestman's criminal conviction under Rule 14e-3 was upheld due to that he knowingly traded while in possession of material nonpublic information relating to a tender offer that derived, directly or indirectly, from a subject corporate source.<sup>68</sup> Thus, while Chestman (like Switzer) avoided Section 10(b) liability because his tipper did not unlawfully tip, Chestman (unlike Switzer) was subject to liability because, unfortunately for Chestman, the structure of the transaction took the form of a tender offer rather than another feasible acquisition alternative, such as a merger or sale of assets. Such inconsistency cannot

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<sup>65</sup> *Id.* See W. Wang & M. Steinberg, *supra* note 10, at 686-691; *supra* notes 45-48 and accompanying text, *infra* note 68 and accompanying text.

<sup>66</sup> *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

<sup>67</sup> *Id.* at 570-571.

<sup>68</sup> *Id.* at 556-564. Note, moreover, that "Rule 14e-3 does not require that a person charged with violating the rule have knowledge that the nonpublic information in his possession relates to a tender offer." *SEC v. Sargent*, 229 F.3d 68, 79 (1<sup>st</sup> Cir. 2000). Accord, *United States v. O'Hagan* 139 F.3d 641, 650 (8<sup>th</sup> Cir. 1998); Securities Exchange Act Release No. 17120 (1980).

be reconciled with market integrity, investor protection, or basic concepts of fair treatment among similar market participants.<sup>69</sup>

The *Chestman* case has another troubling aspect. In ascertaining whether a fiduciary duty existed so as to trigger the disclose or abstain mandate,<sup>70</sup> the Second Circuit held that marriage, standing alone, does not manifest a fiduciary relationship.<sup>71</sup> To have such a relationship of trust and confidence, there must exist other attributes, such as an understanding to keep the material information confidential or a pre-existing pattern of being privy to family business secrets.<sup>72</sup> In addition to minimizing “family values,” one can understandably be concerned about the law giving greater sanctity to a shareholder’s relationship with a director of a publicly-held company (with whom such shareholder has never spoken or met) than to one’s spouse, child, sibling, or parent. Such an approach is an outcome of the U.S. Supreme Court’s focus on the existence of a fiduciary relationship (or a relationship of trust and confidence) based on state law principles. Without a rule premised on equal access, state law notions of fiduciary duty can trigger, as it did in *Chestman*, an absurd result.<sup>73</sup> By adopting Rule 10b5-2,<sup>74</sup> the SEC effectively has nullified this

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<sup>69</sup> See, e.g., *United States v. Naftalin*, 441 U.S. 768 (1979) (stating that purposes of Securities Act include “investor protection,” achieving “a high standard of business ethics . . . in every facet of the securities industry,” and observing that “the welfare of investors and financial intermediaries are inextricably linked – frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole”).

<sup>70</sup> See *supra* notes 33-40 and accompanying text.

<sup>71</sup> *Chestman*, 947 F.2d at 571 (stating that “Keith’s status as Susan’s husband could not itself establish fiduciary status”).

<sup>72</sup> *Id.* at 568-571. But see *SEC v. Lenfest*, 949 F. Supp. 341 (E.D. Pa. 1996); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev’d on other grounds*, 773 F.2d 477 (2d Cir. 1985).

<sup>73</sup> In a separate opinion, Judge Winter reasoned:

“[F]amily members who have benefitted from the family’s control of the corporation are under a duty not to disclose confidential corporate information

aspect of *Chestman*. The rule implicates the misappropriation theory under Section 10(b) when a person receives material nonpublic information from a spouse, child, sibling, or parent unless such person can establish that, due to the particular family relationship, there existed no reasonable expectation of confidentiality.<sup>75</sup> One can certainly question whether the SEC's interpretation will be upheld.<sup>76</sup> After all, the Commission in practical effect has "overturned" a decision rendered by the U.S. Court of Appeals.<sup>77</sup>

From an overall perspective, the conclusion seems inescapable that U.S. law on insider trading is far from ideal. Statutes are largely silent on insider trading,<sup>78</sup> thus leaving this subject to the courts. The U.S. Supreme Court, rejecting the parity of information and equal access doctrines, has focused on traditional state law issues

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that comes to them in the ordinary course of family affairs. In the case of family-controlled corporations, family and business affairs are necessarily intertwined, and it is inevitable that from time to time normal familial interactions will lead to the revelation of confidential corporate matters to various family members. Indeed, the very nature of familial relationships may cause the disclosure of corporate matters to avoid misunderstandings among family members or suggestions that a family member is unworthy of trust."

*Id.* at 579 (Winter, J., concurring in part and dissenting in part).

<sup>74</sup> 17 C.F.R. § 240.10b5-2.

<sup>75</sup> *Id.* See Securities Exchange Act Release No. 43154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319 (2000).

<sup>76</sup> Cf. *The Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC Rule 19c-4).

<sup>77</sup> See Securities Exchange Act Release No. 42259, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,863-82,864 (1999) (release proposing Rule 10b5-2 and expressing dissatisfaction with *Chestman* as being too restrictive).

<sup>78</sup> Statutory treatment exists with respect to certain issues relating to insider trading, such as "short-swing" trading, option traders, the ability of contemporaneous traders to bring a private right of action, the levying of money penalties, and the adoption of specific mechanisms to be implemented by broker-dealers and investment advisers. See, e.g., Sections 16, 20(d), 20A, 21A of the Securities Exchange Act, discussed in W. Wang & M. Steinberg, *supra* note 10, at §§ 6.2, 6.3, 6.8, 7.3.3; *supra* notes 17-20 and accompanying text.

of fiduciary duty.<sup>79</sup> This approach, in turn, as exemplified by the *Chestman* and *Switzer* cases,<sup>80</sup> has led to illogical lower court decisions. On another front, the SEC, seeking to combat restrictive Supreme Court decisions under the Section 10(b) law of insider trading, has asserted expansive interpretations of those decisions.<sup>81</sup>

The Commission, thus faced with frustration regarding its now limited authority under Section 10(b), has responded by promulgating Rules 14e-3 and Regulation FD.<sup>82</sup> The ultimate consequence is all too often the presence of inconsistent and erratic insider trading regulation that ill serves the investing public. Hence, the U.S. framework on insider trading is not one to be emulated. Other countries evidently agree.<sup>83</sup>

## II. REGULATION OF INSIDER TRADING IN OTHER DEVELOPED MARKETS

Unlike the United States where the law of insider trading largely has been formulated by the courts,<sup>84</sup> countries abroad have enacted specific and detailed legislation defining the contours of the insider trading prohibition.<sup>85</sup> Regardless of this codification approach, ambiguities exist in such legislation that await judicial or legislative resolution.<sup>86</sup>

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<sup>79</sup> See *supra* notes, 30, 33-35, 50 and accompanying text.

<sup>80</sup> See *supra* notes 59-73 and accompanying text.

<sup>81</sup> See *supra* notes 52-53 and accompanying text.

<sup>82</sup> See 17 C.F.R. § 243.101; [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,683 (SEC 2000).

<sup>83</sup> See *infra* notes 85-136 and accompanying text.

<sup>84</sup> See *supra* notes 21-48 and accompanying text.

<sup>85</sup> See *infra* notes 87-136 and accompanying text.

<sup>86</sup> See *infra* notes 92-93 and accompanying text.

## A. Use of Statutorily Defined Terms

Unlike the United States, key terms constituting the insider trading offense are set forth by statute.<sup>87</sup> By way of example, the United Kingdom (U.K.) defines inside information as information that “(1) relates to particular securities or their issuers; (2) is specific or precise; (3) has not been made public; and (4) if it were made public would be likely to have a significant effect on the price or value of any security.”<sup>88</sup> An “insider

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<sup>87</sup> See *infra* notes 88-104 and accompanying text.

<sup>88</sup> Criminal Justice Act 1993 (CJA), ch. 36, part V, §§ 56, 60(4), as set forth in Alcock, “United Kingdom” in *International Securities Regulation* vol. 5, bklt. 1, 30 (R. Rosen ed. 1994).

In 1989, the Council of the European Communities promulgated the European Economic Community Directive Coordinating Regulation on Insider Trading. Council Directive 89/592 of November 13, 1989 Coordinating Regulations on Insider Dealing 1989 OJ (L 344) 30 (the Directive). The Directive, for example, sets forth minimum standards for defining the concepts “inside information” and “insider” with respect to which Member States of the European Union must comply. Directive art. 5. Nonetheless, significant details regarding methods of enforcement are left principally to the Member States. Directive art. 8. See Pingel, “The EC Directive of 1989, in *Insider Trading: The Laws of Europe, the United States and Japan* 5, 5-6 (E. Gaillard ed. 1992).

Article I of the Directive provides that inside information is “information which has not been made public of a precise nature . . . which, if it were made public, would be likely to have a significant effect on the price of the . . . security.” Directive art. 1. Article 2 sets forth that an insider is “any person who . . . by virtue of his membership of the administrative, management or supervisory bodies of the issuer, by virtue of his holding in the capital of the issuer, or because he has access . . . by virtue of the exercise of his employment, profession or duties, possesses inside information [and takes] advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer . . . to which that information relates.” Directive art. 2. Article 4 provides that a “secondary insider” is “any person [other than a primary insider] who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than a [primary insider].” Directive art. 4.

The Directive, providing minimum standards only, leaves to the judgment of the

fact” under German law is “knowledge of a fact not publicly known relating to one or more issuers of insider securities or to insider securities and which fact is capable of substantially influencing the price of the insider securities in the event of it becoming publicly known.”<sup>89</sup> Other countries similarly define by statute the elements of an inside fact or privileged information.<sup>90</sup> In addition, other key concepts are defined by statute, including, for instance, those persons who are deemed: insiders, to have a “special relationship” with the company, or to have “access” to insider information.<sup>91</sup>

Note that a number of interpretive issues remain under these statutes. Under the U.K. framework, for example, when is information “specific or precise” rather than general or not specific? Is information relating to the issuer engaging in relatively preliminary merger negotiations with a prospective suitor precise or not

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Member States whether to adhere to more stringent requirements than those promulgated in the Directive. Directive art. 6. The Directive mandates that each Member State designate competent authorities “to ensure that the provisions adopted pursuant to [the] Directive are applied [and that those authorities] be given all supervisory and investigatory powers that are necessary for the exercise of their functions.” Directive art. 6. The Directive declines to require whether administrative, civil or criminal sanctions should be implemented by each Member State for enforcement purposes. Rather, Article thirteen provides that “[e]ach Member State shall determine the penalties to be applied for infringement of the measures taken pursuant to [the] Directive.” See Pincus, *supra* note 1, at 6-21; Steinberg, *supra* note 1, at 122-123. See also, “New Curbs on Insider Trading, Market Abuse Agreed to by EU Parliament,” 34 Sec. Reg. & L. Rep. (BNA) 432 (2002).

<sup>89</sup> Securities Act § 13. See Hickinbotham & Vaupel, “Germany” in *International Insider Dealing* 129, 134 (M. Stamp & C. Welsh eds. 1996).

<sup>90</sup> See, e.g., France – Commission des Opérations de Bourse (COB) Regulation 90-08; Italy – Consolidated Act on Financial Intermediation Art. 180, para. 3, implemented by CONSOB Regulation No. 11520. See also, Steinberg, *supra* note 1, at 130-132, 138-139.

<sup>91</sup> See, e.g., European Community Directive on Insider Trading, note 88 *supra*; Australia – Corporations Law § 1002G(1); Canada – Ontario Securities Act § 76(1), 76(5).

sufficiently specific for purposes of the statute?<sup>92</sup> Under German law, when is a fact not publicly known so as to become an “insider fact?”<sup>93</sup>

Also, contrary to the U.S. definition, the concept of materiality is connected to the information’s impact on market price.<sup>94</sup> The U.S. standard, focusing on whether the subject information would assume importance to the mythical “reasonable” investor in making his investment decision,<sup>95</sup> has not been adopted with great frequency elsewhere.<sup>96</sup> To illustrate the widespread rejection of the U.S. definition of materiality, the laws of the following jurisdictions focus their inquiry

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<sup>92</sup> The ambiguity of the United Kingdom’s definition of inside information has been criticized. See Stamp & Welsh, “United Kingdom” in *International Insider Dealing* 95, 100 (M. Stamp & C. Welsh eds. 1996). Note that the French judiciary has held that “privileged information” encompasses negotiations relating to a prospective takeover offer by a French company seeking to acquire the securities of a publicly-held U.S. corporation. See CA Paris, 6 July 1994, *Les Petites Affiches (Petites Affiches)* No. 137, 16 Nov. 1994, p. 17, note Ducouloux-Favard, discussed in, Peterson, “France” in *International Insider Dealing* 152, 156 (M. Stamp & C. Welsh eds. 1996).

<sup>93</sup> See Krause, *The German Securities Trading Act (1994): A Ban on Insider Trading and an Issuer’s Affirmative Duty to Disclose Material Nonpublic Information*, 30 Int’l Law. 555, 562 (1996) (“Neither the German Act nor the EC Insider Trading Directive offer guidance as to when information should be considered known to the public.”) Cf. Australian Corporations Law § 1002B(2) (setting forth that information is generally available if “(a) it consists of readily observable matter; or (b) without limiting the generality of paragraph (a), both the following subparagraphs apply: (i) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information; and (ii) since it was so made known, a reasonable period for it to be disseminated among such persons has elapsed”).

<sup>94</sup> See *infra* notes 97-103 and accompanying text.

<sup>95</sup> See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>96</sup> See Article 1 of the EC Directive on Insider Trading, note 88 *supra*; *infra* notes 97-103 and accompanying text.

on the information's effect on the market price of the subject security: (Ontario) Canada,<sup>97</sup> Mexico,<sup>98</sup> United Kingdom,<sup>99</sup> France,<sup>100</sup> Germany,<sup>101</sup> Italy,<sup>102</sup> and Australia.<sup>103</sup> Indeed, relatively few countries, such as Japan,<sup>104</sup> follow the U.S. approach.

Hence, although awaiting judicial clarification for unresolved issues, the insider trading statutes outside of the United States set forth the key terms and definitions that comprise the offense. As will

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<sup>97</sup> Ontario Securities Act § 1(1) (defining a material fact as a “fact that significantly affects or would reasonably be expected to have a significant effect on, the market price or value of securities [of the subject issuer]”).

Note that there is no federal securities law in Canada. Rather, regulation is provided by each of that country's ten provinces and two territories. The Ontario securities legislation is viewed as the most significant and will be used as the exemplar in this paper. See generally Anisman, *The Proposals for a Securities Market Law for Canada: Purpose and Process*, 19 Osgoode Hall L.J. 330 (1981).

<sup>98</sup> Securities Market Law art. 16-Bis.

<sup>99</sup> Criminal Justice Act § 60(4).

<sup>100</sup> Commission des Opérations de Bourse Art. 1 (defining privileged information as “any precise non-public information . . . which, if made public, might affect the price of the security”).

<sup>101</sup> Security Act § 13.

<sup>102</sup> Consolidated Act on Financial Intermediation Art. 180, para. 3. Cf. former Law No. 157 art. 3. See Casella, “Italy” in *Insider Trading: The Laws of Europe, the United States and Japan* 109, 112-113 (E. Gaillard ed. 1992). See generally Ruggiero, *The Regulation of Insider Trading in Italy*, 22 Brook. J. Int'l L. 157 (1996).

<sup>103</sup> Corporations Law § 1002G(1) (setting forth that the information, if it were generally available, “might have a material effect on the price or value of [the subject] securities”).

<sup>104</sup> Securities and Exchange Law art. 166, para. 2 (defining material facts as encompassing those facts “which may have significant influence on the investment decision of investors”). See Steinberg, *supra* note 1, at 146 (and sources cited therein).

be examined below, the fiduciary duty (or trust and confidence) analysis embraced by the U.S. Supreme Court has been broadly rejected elsewhere.<sup>105</sup>

## **B. General Adherence to the “Access” Standard**

Not surprisingly, other jurisdictions soundly have rejected the U.S. fiduciary relationship (or relationship of trust and confidence) model to define the scope of illegal insider trading and tipping.<sup>106</sup> First, the U.S. approach focuses on the presence or absence of relatively complex inquiries to ascertain whether the insider trading proscription prevails in the particular setting. For example: Is there a fiduciary relationship present?<sup>107</sup> What type of relationship is deemed to be fiduciary or one of trust and confidence?<sup>108</sup> Who is a quasi-insider and under what circumstances?<sup>109</sup> What facts must be shown for there to be misappropriation of the subject information?<sup>110</sup> Must the inside trader in fact “use” or merely be “in possession of” the subject information at the time of the transaction(s)?<sup>111</sup> What must be established to prove that one tipped for “personal benefit” and what constitutes an “improper personal

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<sup>105</sup> See *infra* notes 106-136 and accompanying text.

<sup>106</sup> See *infra* notes 120-136 and accompanying text.

<sup>107</sup> See *Chiarella v. United States*, 445 U.S. 222 (1980); *supra* notes 33-37 and accompanying text.

<sup>108</sup> See *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc); *supra* notes 66-72 and accompanying text.

<sup>109</sup> See *Dirks v. SEC*, 463 U.S. 646, 655 n. 14 (1983).

<sup>110</sup> See *United States v. O’Hagan*, 117 S. Ct. 2199 (1997); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

<sup>111</sup> See SEC Rule 10b5-1, 17 C.F.R. § 240.10b5-1; *supra* notes 52-53, 81 and accompanying text.

benefit?”<sup>112</sup> To leave these inquiries to ad hoc adjudication and occasional SEC rulemaking<sup>113</sup> may be tolerable for the United States with its zest for litigation and its abundance of lawyers, regulators, and judges. Such an approach, representing the antithesis of cost-effectiveness, justifiably garners little support elsewhere.<sup>114</sup>

Moreover, as a matter of fairness, the U.S. framework has significant loopholes. For example, should the loose-lip executive and her tippees avoid insider trading liability when those tippees knowingly trade on material nonpublic information?<sup>115</sup> Should one be criminally convicted or be totally exonerated on the sole distinction whether the confidential information related to a tender offer rather than a merger transaction?<sup>116</sup> Should a close relative or good friend be able to trade legally on material nonpublic information when he inadvertently learns of such information when visiting the insider at her home or office?<sup>117</sup> By adhering to a fiduciary relationship like-model that has been rejected by the SEC in the tender offer scenario,<sup>118</sup> the U.S.

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<sup>112</sup> See *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984); *supra* notes 59-65 and accompanying text.

<sup>113</sup> See, e.g., SEC Rules 10b5-1 and 10b5-2. 17 C.F.R. § 240.10b5-1, 240.10b5-2; *supra* notes 52-53, 74-77 and accompanying text.

<sup>114</sup> See *infra* notes 120-136 and accompanying text.

<sup>115</sup> Such conduct today is governed by Regulation FD. See *supra* note 82 and accompanying text.

<sup>116</sup> See *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc); *supra* notes 58-83 and accompanying text.

<sup>117</sup> Cf. Trib. Corr. Paris, 15 Oct. 1976, JCP 1977, II 18543-D. 1978.381 (architect deemed insider due to his becoming privy to confidential information while visiting his client’s office), discussed in, Borde. “France” in *Insider Trading in Western Europe: Current Status* 59, 65 (G. Wegen & H. Assmann eds. 1994).

<sup>118</sup> See Rule 14e-3, 17 C.F.R. § 240.14e-3; *supra* notes 45-48 and accompanying text.

insider trading approach unduly complicates an already complex area and at time smacks of unfairness among similarly situated market participants.<sup>119</sup> For these reasons, many countries opt for an insider trading proscription premised on the “access” doctrine.<sup>120</sup> As a generalization, this standard prohibits insider trading by those who have unequal access to the material nonpublic information. This concept may extend the insider trading prohibition to tippees who receive the subject information from traditional insiders or others who, due to their office, employment, or profession, have access to such information.<sup>121</sup>

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<sup>119</sup> See *supra* notes 49-83 and accompanying text.

<sup>120</sup> EC Directive on Insider Trading, note 88 *supra*; *infra* notes 122-127 and accompanying text.

<sup>121</sup> See *infra* notes 122-127 and accompanying text.

This general approach is implemented by such jurisdictions as, for example, the United Kingdom,<sup>122</sup> France,<sup>123</sup> Germany,<sup>124</sup> Italy,<sup>125</sup> (Ontario) Canada,<sup>126</sup> and Mexico.<sup>127</sup>

A significantly smaller number of jurisdictions opt for an expansive approach premised on the parity of information principle.<sup>128</sup> For example, Australia’s prohibition against insider trading generally extends to any person or entity who possesses confidential price sensitive information.<sup>129</sup> Under the Australian framework, one is deemed an insider, thereby becoming subject to the insider trading and tipping proscriptions, by “(a) possess[ing] information that is not generally available but, if the information were generally available, a reasonable person would expect it to have a material effect on the

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<sup>122</sup> See Criminal Justice Act §§ 52, 57; *infra* note 132 and accompanying text.

<sup>123</sup> Hence, under Regulation 90-08, the following are defined as insiders: “(a) [P]ersons holding privileged information by reason of their capacity as members of management, board of directors of an issuer, or by reason of their functions which they exercise with respect to an issuer; (b) [p]ersons holding privileged information by reason of the planning and execution of a financial operation; (c) [p]ersons to whom privileged information is disclosed during the exercise of their professional activities or functions; and (d) [p]ersons who, with full knowledge of the facts, possess privileged information originating directly or indirectly from [any of the foregoing insiders].”  
*Id.* See Steinberg, *supra* note 1, at 138.

<sup>124</sup> Securities Act § 13(1). See generally Krause, note 93 *supra*; von Dryander, *The German Securities Trading Act: Insider Trading and Other Secondary Market Regulation*, 9 Insights No. 1, at 26 (1995).

<sup>125</sup> Consolidated Act on Financial Intermediation, art. 180, para. 3. See Steinberg, *supra* note 1, at 132.

<sup>126</sup> OSA § 76(5).

<sup>127</sup> See “Amendments to the Mexican Securities Law,” 465 Int’l Fin. L. Rev. 83 (2001).

<sup>128</sup> See *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc); *supra* note 25 and accompanying text.

<sup>129</sup> See Corporations Law § 1002G.

price or value of securities of a body corporate; and (b) . . . know[ing], or ought reasonably know[ing] that (i) the information is not generally available; and (ii) if it were generally available, it might have a material effect on the price or value of those securities.<sup>130</sup>

### C. Tipping Liability

With respect to tipping, like the liability of insiders and access persons for trading, the U.S. approach has been thoroughly rejected. Representing an expansive position, Australia, for example, subjects any tippee (regardless how remote), who knowingly possesses material nonpublic information, from trading on or tipping such information.<sup>131</sup> Similarly, the United Kingdom imposes a broad prohibition against trading and tipping for those who knowingly receive material nonpublic information, directly or indirectly, from an insider.<sup>132</sup>

A number of other countries have approaches that are more straightforward than the U.S. standard but at times not as encompassing. Under German law, for instance, primary insiders neither may trade nor tip. Recipients of material nonpublic information communicated by a primary insider, while subject to the

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<sup>130</sup> *Id.* See Steinberg, *supra* note 1, at 142.

<sup>131</sup> *Id.* See R. Tomasic & S. Bottomley, *Corporations Law in Australia* 698-699 (1995). See generally P. Redmond, *Companies and Securities Law* (2d ed. 1992).

<sup>132</sup> Criminal Justice Act §§ 52, 57. See Herrington & Glover, “The United Kingdom” in *Insider Trading in Western Europe: Current Status* 33, 43 (G. Wegen & H. Assmann eds. 1994); Stamp & Welsh, *supra* note 92, at 109.

trading proscription, are not themselves precluded from tipping the subject information to others.<sup>133</sup>

France,<sup>134</sup> Italy,<sup>135</sup> and Japan<sup>136</sup> have similar provisions.

### III. COMMENTS FAVORING U.S. REGULATION

The foregoing discussion illustrates that the U.S. approach with respect to insider trading lags behind other established markets in terms of promoting investor protection and market integrity. Nonetheless, in practical reality, the U.S. regime is viewed as preeminent irrespective of its shortcomings. The succinct explanation is the implementation of an effective enforcement and remedial U.S. framework that receives widespread support by market participants as well as the general populace.<sup>137</sup>

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<sup>133</sup> Securities Act § 14(1)-(2). See Steinberg, *supra* note 1, at 128-129:

“Primary insiders are prohibited from trading on inside information for their own account or for the account of others, conveying inside information to others without proper authorization, and making recommendations to a third party to trade based upon inside information (tipping). Secondary insiders are prohibited from trading for their own account or for the account of others. Unlike primary insiders, secondary insiders are neither prohibited from disclosing information to other people nor from tipping. However, the recipients of such information would then become secondary insiders (tippees) and thus would be prohibited from trading on the inside information for their own account or for the account of others. Nonetheless, tippees can continue to pass along inside information provided that they do not trade on it themselves or for the account of others. This result may be explained as a means of facilitating the free flow of information in order to more expeditiously transform non-public inside information into public information.”

*Id.* See sources cited notes 93, 124 *supra*.

<sup>134</sup> Commission des Opérations de Bourse Regulation 90-08 arts. 2-5; art. 10-1 of Ordinance No. 67-833. See Borde, *supra* note 117, at 66-69.

<sup>135</sup> Consolidated Act on Financial Intermediation No. 58, art. 180, paras. 1, 2, discussed in Steinberg, *supra* note 1, at 132-133.

<sup>136</sup> Securities and Exchange Law art. 166, paras. 1, 3. See Kobayashi, Mihara & Sugimoto, “Japan: in *International Insider Dealing* 321, 334-335 (M. Stamp & C. Welsh eds. 1996).

<sup>137</sup> See Steinberg, *supra* note 1, at 259.

As seen by the experiences of many countries, statutes that impose strict standards (such as with respect to insider trading) are meaningful only to the extent that they are enforced with some regularity. The lack or inadequacy of effective government personnel, resources, and surveillance poses little deterrent to prospective violators. Consequently, competent staff must be retained by the applicable regulator and be provided with the appropriate resources to conduct meaningful surveillance and prosecution.<sup>138</sup> This commitment has not been forthcoming with great vigor by several countries that have more rigorous standards than the United States.<sup>139</sup>

Along with this much relaxed enforcement of statutorily strict standards in the applicable country often are found cultural attitudes acquiescing in insider trading.<sup>140</sup> Such practices are perceived by affected participants as embedded in that securities market and as a way that business relations have been conducted for decades (if not centuries).<sup>141</sup> This attitude may deter regulators from initiating actions against

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<sup>138</sup> *Id.* at 261. See “New Curbs on Insider Trading, Market Abuse Agreed to by EU Parliament,” 34 *Sec. Reg & L. Rep.* 432, 433 (2002) (stating that the U.S. SEC’s budget is nearly fifty times larger than Germany’s federal regulator).

<sup>139</sup> See, e.g., Tomasic, *Insider Trading Law Reform in Australia*, 9 *Comp. and Sec. L.J.* 121 (1991).

<sup>140</sup> For example, although having a relatively detailed insider trading proscription, South Africa has initiated few, if any, criminal prosecutions. See Zyl, *South Africa Insider Trading Regulation and Enforcement*, 15 *Comp. Law. No.* 3, at 92 (1994). Although viewed as doing more to combat insider trading than most jurisdictions, “prosecution of insider trading [in Canada] remains minimal.” Nasser, *The Morality of Insider Trading in the United States and Abroad*, 52 *Okla. L. Rev.* 377, 385 (1999). With respect to Japan, that country is perceived as an “‘insider’s heaven’ where people rampantly profit from inside information with little detection or prosecution.” *Id.* at 382, quoting Akashi, *Regulation of Insider Trading in Japan*, 89 *Colum. L. Rev.* 1296, 1302 n. 45 (1989).

<sup>141</sup> See Tunc, *A French Lawyer Looks at American Corporation Laws and Securities Regulation*, 130 *U. Pa. L. Rev.* 757, 762 (1982) (stating that in France tipping of material nonpublic information is perceived as “a social duty . . . expected of relatives and friends”);

purportedly distinguished business executives who are often viewed with admiration and respect. Principal reliance on a criminal mode of enforcement (due to that many countries do not adequately provide for civil enforcement by either the government or allegedly aggrieved private parties<sup>142</sup>) may accentuate this reluctance.<sup>143</sup> Respected executives thus are faced with penal sanctions in a culture that has not embraced the evils of such “gentlemen” offenses.<sup>144</sup> Courts also play a key role in this process, often refusing to convict a defendant on the basis of circumstantial evidence<sup>145</sup> and imposing relatively lenient sanctions when guilt has been established.<sup>146</sup> Although recent developments in certain countries suggest that more successful surveillance and enforcement practices are being deployed,<sup>147</sup> a long road must be traversed to approach the effectiveness of U.S. civil and criminal enforcement.<sup>148</sup>

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sources cited note 140 *supra*.

<sup>142</sup> See, e.g., Steinberg, *supra* note 1, at 148 (Japan); Nasser, *supra* note 140, at 380-384; Note, *The Regulation of Insider Trading in Japan: Introducing a Private Right of Action*, 73 Wash. U.L.Q. 1399 (1995).

<sup>143</sup> See Steinberg, *supra* note 1, at 264.

<sup>144</sup> *Id.*

<sup>145</sup> See Tomasic & Pentony, *The Prosecution of Insider Trading: Obstacles to Enforcement*, 22 Aust. & N.Z. Crimin. 65, 65-66 (1989); McDonald, “Australia” in *International Insider Dealing* 439, 442 (M. Stamp & C. Welsh eds. 1996).

<sup>146</sup> In Germany, the first conviction for insider trading was not procured until 1995; moreover, no prison sentence was ordered. See *Commerzbank Declines to Comment on Report of Insider-Trading Case*, Wall St. J., Aug. 22, 1995, at 10. See also, *Ex-Lawyer Gets Suspended Term for Insider Trading*, Japan Weekly Monitor, Aug. 4, 1997.

<sup>147</sup> See Steinberg, *supra* note 1, at 121-140, 214-237.

<sup>148</sup> See “New Curbs on Insider Trading, Market Abuse Agreed to by EU Parliament,” 34 Sec. Reg. & L. Rep.(BNA) 432, 433 (2002) (stating that from 1995 through 2000, there were “only 13 successful prosecutions leading to criminal penalties across the 17 nations of [the] European Union and its neighbors in the European Economic Area”); Nasser, *supra* note 140,

Hence, irrespective of the apparent laxity and confusion in the U.S. law of insider trading, the U.S. regime remains preeminent. The SEC's important role as regulator, with its capable personnel, resources, and surveillance, is perhaps the most significant ingredient comprising effective enforcement of the U.S. securities laws.<sup>149</sup> In addition, enhanced criminal prosecution for insider trading has become an accepted component of the enforcement landscape.<sup>150</sup> As a further layer of enforcement, allegedly aggrieved traders may institute civil actions seeking damages against those who illegally traded on the basis of or tipped material nonpublic information.<sup>151</sup>

In the United States, the impropriety of insider trading and like offenses<sup>152</sup> is generally accepted by market participants, the public, and the judiciary. In other words, unlike many other countries, the cultural attitudes prevalent in the U.S. favor relatively rigorous enforcement and prosecution of these offenses.<sup>153</sup> Judges contribute to this atmosphere by upholding insider trading convictions based on circumstantial evidence<sup>154</sup> and by, pursuant to the federal sentencing guidelines,<sup>155</sup> imposing lengthy periods of incarceration

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at 377 (stating that in addition to Canada and Japan, “insider trading seems to go largely unpunished in Australia, France, Germany, and Mexico”).

<sup>149</sup> See D. Vise and S. Coll, *Eagle on the Street* (1991).

<sup>150</sup> See, e.g., Section 32(a) of the Securities Exchange Act; *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

<sup>151</sup> See, e.g., Sections 10(b), 20A of the Securities Exchange Act; *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

<sup>152</sup> Such offenses include stock manipulation, parking of securities, and “scalping.” See generally N. Poser, *Broker-Dealer Law and Regulation* (1995).

<sup>153</sup> See Nasser, *supra* note 140, at 388-393. See generally W. Wang & M. Steinberg, note 10 *supra*.

<sup>154</sup> See, e.g., *SEC v. Sargent*, 229 F.3d 68, 75 (1<sup>st</sup> Cir. 2000) (“Circumstantial evidence, if it meets all the other criteria of admissibility, is just as appropriate as direct evidence . . .”),

where circumstances warrant.<sup>156</sup> Thus, as compared to other jurisdictions, U.S. enforcement in this area is effective, thereby inducing law compliance<sup>157</sup> and facilitating market integrity.<sup>158</sup>

#### IV. CONCLUDING OBSERVATIONS

U.S. regulation of insider trading practices is far from ideal. Without adequate justification, ambiguity, complexity and uneven treatment of similarly situated market participants too often prevail. Perhaps recognizing these shortcomings, countries with developed securities markets largely have declined to adhere to U.S. standards in the insider trading area. The approaches adopted by many countries abroad thus represent an effort to provide clear statutory direction with respect to the insider trading proscription. Focusing on the statutes by themselves, these countries may have largely achieved their objectives.<sup>159</sup>

Nonetheless, due to such deficiencies as inadequate funding, personnel, resources, and surveillance, ineffective enforcement generally has been predominant in markets abroad. Laws normally are as potent as

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*quoting, United States v. Gamache*, 156 F.3d 1, 8 (1<sup>st</sup> Cir.1998). Accord, *SEC v. Euro Security Fund*, 2000 WL 1376246 (S.D.N.Y. 2000).

<sup>155</sup> 18 U.S.C. §§ 3551-3559, 3561-3566, 3571-3574, 3581-3586; 28 U.S.C. §§ 991-998. See generally, Symposium, *The Federal Sentencing Guidelines: Ten Years Later*, 91 Nw. U. L. Rev. 1231 (1997).

<sup>156</sup> See, e.g., *United States v. O'Hagan*, 139 F.3d 641, 653-656 (8<sup>th</sup> Cir. 1998); *United States v. Cusimano*, 123 F.3d 83, 90-91 (2d Cir. 1997).

<sup>157</sup> See Wang & Steinberg, *supra* note 10, at 807-909.

<sup>158</sup> *Id.* at 547-672; Nasser, *supra* note 140, at 388-394; Phelan, *Integrity Is A Necessity On Wall Street*, N.Y. L.J., March 16, 1987, at 29. But see *The Epidemic of Insider Trading*, Bus. Wk., April 29, 1985, at 80-81. See generally J. Macey, *Insider Trading: Economics, Politics and Policy* (1991); Strudler & Orts, *Moral Principle in the Law of Insider Trading*, 78 Tex. L. Rev. 375 (1999).

<sup>159</sup> See *supra* notes 120-136 and accompanying text.

their effective implementation. The deterrent impact of rigorous statutes recedes drastically as the likelihood of successful usage lessens. Hence, statutes that are intended to enhance market integrity and investor protection have relatively negligible effect if there exists widespread noncompliance. The lack of successful enforcement thereby facilitates disobedience by market participants with applicable statutory mandates.<sup>160</sup>

This scenario explains why the U.S. markets are perhaps the most admired in the world. As discussed above, the legal prescriptions relating to insider trading are not without their shortcomings. Although far from ideal, the standards adopted are perceived as within the range of acceptability and have become embedded in the ethos of the U.S. capital markets. Even more significant, these standards are effectively enforced by the U.S. SEC, the U.S. Department of Justice in criminal proceedings, and private litigants who seek damages from alleged violators. Hence, reasonably effective enforcement of statutory, judicial, and regulatory pronouncements that define specified conduct as being unlawful enhances compliance with the rule of law as well as investor confidence in market integrity.

Many countries, including those that are members of the European Community, are devoting significantly greater resources toward successful implementation of their statutory mandates relating to abusive practices such as insider trading. Sufficient allocation of resources, of course, encompasses procuring adequate funding, personnel, and technological surveillance mechanisms. Agendas also should include educational or “enlightenment” missions to stress the importance of these statutory prohibitions to affected constituencies, such as corporate insiders, bankers, legislators, judges, and the investing public. Once reasonably successful enforcement of legal mandates ensues and is perceived in that fashion by market participants, the affected country’s securities markets will be deemed more attractive as a forum for both capital raising and investment purposes.<sup>161</sup>

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<sup>160</sup> See Black, *The Core Institutions That Support Strong Securities Markets*, 55 *Bus. Law.* 1565, 1576-1578 (2000); Steinberg, *Emerging Capital Markets: Proposals and Recommendations for Implementation*, 30 *Int’l Law.* 715, 723-725 (1996).

<sup>161</sup> See sources cited *supra* notes 149-158 and accompanying text.

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