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The Globalization of Insider Trading Prohibitions

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Franklin A. Gevurtz*

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I. INTRODUCTION

When the organizers of this symposium asked me to present a paper involving the regulation of international financial services in the twenty-first century, my initial reaction was “What do I look like, a banker?” Yet, the importance of my field, corporate law, to the regulation of international financial services becomes evident with some further reflection. One potentially significant trend in international finance underway as the new century begins is the desire of nations around the world to develop stock markets which are similar to the United States.¹ The goal is for equity from dispersed investors to supplement, if not significantly supplant, the role of banks in providing corporate finance. Time does not permit this paper to canvass this entire trend. Instead, this paper will focus on the spread of one particular type of regulation aimed at developing deep and liquid stock markets around the world, specifically the prohibition of trading on inside information. The hope is that this examination of one particular type of regulation can serve to

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1. *Infra* text accompanying notes 29-31.

illustrate the broader forces at work as nations around the world seek to imitate United States' stock exchanges.

This paper will examine the globalization of insider trading prohibitions in four steps. The first step, in Part II of this paper, is to describe the explosive growth which has occurred in the number of nations whose laws prohibit trading on inside information concerning stock. Next, Part III of this paper looks at some of the principal variations in the specific prohibitions that nations have enacted. Part IV of this paper then analyzes whether insider trading prohibitions are likely to achieve the goals of the nations who enacted them. Finally, Part V concludes this paper by turning the spotlight back on the United States, and asks whether there are any lessons Americans can learn from the spread of insider trading prohibitions abroad.

II. THE SPREADING PROHIBITION ON INSIDER TRADING

Around a decade ago, I decided to pose a pure policy question on the final examination for my Business Associations course. The question asked the students to assume that they had been retained as consultants by the government of an Eastern European country which just switched from a command to a market economy and was interested in developing private ownership of corporations and a stock market. The government of this country wanted advice on what law it should have with respect to trading stock based upon information known to one party to the trade but not to the other party (in common parlance, trading on inside information, or insider trading). The overwhelming majority of students responded by stating that this Eastern European country should prohibit trading on inside information along lines following the students' understanding of United States' law.

This result should not have been surprising. Despite efforts of professors to instill critical policy analysis of laws, most American law students, and indeed most American lawyers and lay persons, seem imbued with an instinctive belief that American laws must be the best laws.² Still, I felt I had grounds for disappointment. Unlike the situation with murder, robbery or bribery,³ there has been no longstanding or universal condemnation among human civilizations of transacting business based upon inside information.⁴ Indeed, the United States appears to have been the first country to prohibit trading by corporate insiders on inside

2. I also suspect that many students advocated adoption of the American law simply because this allowed these students to demonstrate their knowledge of the specifics of the prohibition under United States' law.

3. See, e.g., JOHN T. NOONAN, JR., *BRIBES* (1984) (discussing historical universal condemnation of bribery).

4. See, e.g., Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 *GEO. L.J.* 1083, 1091-1102 (1985) (discussing traditional common law acceptance of insider trading); Ramzi Nasser, *The Morality of Insider Trading in the United States and Abroad*, 52 *OKLA. L. REV.* 377, 377 (1999) (stating that Japanese and many other persons outside of the United States do not consider insider trading immoral).

information.⁵ What is more, the prohibition on insider trading in the United States arose as an almost accidental byproduct from the Securities Exchange Commission's (SEC) adoption of a rule whose language and initial purpose attacked very different conduct.⁶ In 1967, France became the second country to enact an insider trading prohibition.⁷ Although the 1980s witnessed an increasing number of nations adopting laws against insider trading, only thirty-four nations had laws prohibiting insider trading by 1990.⁸ Of those countries, only nine had enforced their law by prosecuting someone for insider trading.⁹ Hence, when my students wrote their answers, most nations seemed to be getting along without laws prohibiting insider trading. At the same time, a respectable set of academic commentary had arisen in the United States criticizing the prohibition on insider trading.¹⁰

Jingoist as their answers might have been, my students turned out to be rather prescient, at least insofar as they advocated some prohibition of trading on inside information (as opposed to following precisely the United States' rules). The decade of the 1990s witnessed an explosion in the number of nations adopting laws prohibiting insider trading. By 2000, eighty-seven countries had adopted laws prohibiting insider trading;¹¹ and, suggesting this was not all cosmetic, thirty-eight nations had undertaken at least one prosecution of insider trading under their laws.¹²

Several events contributed to this growth. My final examination question reflects one of these events. The fall of the iron curtain and the development of market economies in the formerly socialist economies of Eastern Europe led to the spread of stock markets. This, in turn, led some nations, who previously had little reason for concern over insider trading (because they had little or no stock trading in any event), to enact insider trading prohibitions.¹³ Yet, this explanation covers only a small part of the story. While the 1990s witnessed a significant increase in the number of countries with stock markets, the number of nations with insider trading regulations grew much more rapidly. As a result, the world evolved from a situation, at the start of the 1990s, in which the majority of countries with stock markets did

5. Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, at <http://papers.ssrn.com/sol3/delivery.cfm/991215308.pdf?abstractid=200914>, at 11 (last visited Oct. 30, 2001) (copy on file with *The Transnational Lawyer*).

6. *Infra* text accompanying notes 36-38.

7. Bhattacharya & Daouk, *supra* note 5, at 12. While France was the first nation outside the United States to outlaw some forms of insider trading, the province of Ontario, Canada adopted an ordinance imposing administrative and civil liability for insider trading in 1966. Nasser, *supra* note 4, at 385.

8. Bhattacharya & Daouk, *supra* note 5, at 3.

9. *Id.*

10. See generally HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKETS* (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Michael Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980).

11. Bhattacharya & Daouk, *supra* note 5, at 3.

12. *Id.*

13. See, e.g., Dariusz M. Budzen & Ania M. Frankowska, *Prohibitions Against Insider Trading In the United States and the European Community: Providing Guidance for Legislatures of Eastern Europe*, 12 BOS. U. INT'L L. J. 91, 125-26 (1994) (describing Polish law).

not prohibit insider trading, to a situation where the overwhelming majority of countries with stock markets had enacted such a prohibition by the year 2000.¹⁴

A significant component of the move of nations with existing stock markets to adopt insider trading prohibitions occurred in the European Community (now the European Union or EU). Toward the end of 1989, the Council of European Communities adopted its Insider Trading Directive.¹⁵ At the time, some European Community members (such as England) had laws prohibiting certain forms of insider trading,¹⁶ while other members (such as Italy and Ireland) had no prohibition,¹⁷ or (as with Germany) addressed the matter only through voluntary codes of conduct.¹⁸ The EU Directive commanded all member nations to enact laws by 1992 prohibiting insider trading within certain minimum guidelines. The result of the EU Directive was to force members such as Italy¹⁹ and Germany²⁰ to enact (over significant internal opposition and resulting delay in Germany) insider trading prohibitions. Other member nations, such as England, had to modify their insider trading prohibitions to meet the EU Directive's minimum mandates.²¹

European nations were hardly alone among the countries with established stock markets in adopting insider trading prohibitions during the late 1980s and the 1990s. For example, a year before the EU Directive, at the opposite end of the world, Japan amended its securities laws to add a provision explicitly making some insider trading a crime.²² Before this time, Japanese authorities had refused to interpret the broad anti-fraud provision in the Japanese securities law to reach insider trading,²³ and had authorized, but never imposed, administrative sanctions on certain insiders

14. Before 1990, just over half of the developed countries with stock markets had laws prohibiting insider trading, while less than 40% of the countries with emerging markets did. By 2000, 87 of the 103 nations with stock markets, including all of the developed countries, and 80% of the countries with emerging markets had such laws. Bhattacharya & Daouk, *supra* note 5, at 3, 11.

15. Council Directive 89/592 of November 13, 1989 Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30 [hereinafter EU Directive].

16. Company Securities Insider Dealing Act of 1985.

17. Budzen & Frankowska, *supra* note 13, at 115 n.153.

18. *Id.* at 115 n.152.

19. For a discussion of the Italian insider trading prohibition, see generally Eugenio Ruggiero, *The Regulation of Insider Trading In Italy*, 22 BROOK. J. INT'L L. 157 (1996).

20. For a discussion of the German insider trading prohibition, see generally James H. Freis, Jr., *An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland*, 19 B.C. INT'L & COMP. L. REV. 1 (1996).

21. See, e.g., Criminal Justice Act, 1993, §§ 52, 56, 60(4). For a discussion of the English insider trading prohibition, see Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. CIN. L. REV. 1133, 1148-49 (1998).

22. Shoken torihikiho [Securities and Exchange], Law No. 25 of 1948, arts. 190-2, 190-3 [hereinafter SEL]. For a translation of the Japanese insider trading provisions, see generally Tomoko Akashi, *Note, Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296 (1989).

23. The Japanese refused such interpretation even though this provision tracked the language of the American securities law rule (Rule 10b-5) which, as discussed later in this paper, serves as the basis for the United States' insider trading prohibition.

trading on confidential information obtained in the course of employment.²⁴ Even some nations that already had insider trading laws amended their statutes during this time to strengthen the prohibition. For instance, in 1991, Australia replaced its previous complex and detailed statutory scheme with a much simpler and extraordinarily broad prohibition.²⁵

Several forces seem to have led to the dramatic recent growth in insider trading prohibitions even among nations which already had stock markets. One force may be simply instinctive imitation spawned by the growing cultural and economic dominance of the United States at the close of the Twentieth Century. In other words, the spread of insider trading prohibitions might reflect nothing more rational than the securities law mirror of the spread of American rock-and-roll, Levi's Jeans, and McDonald's hamburgers. Indeed, the timing of the spread of insider trading prohibitions lends credence to this explanation. The 1980s witnessed highly publicized insider trading prosecutions in the United States.²⁶ The important agent of dispersing American culture, Hollywood, did its part to vilify insider trading at about this time in the movie *Wall Street*.²⁷ As a result, instances of insider trading outside the United States—such as a 1987 incident involving Hashin Sogo Bank's disposal of its shares in Tatecho Chemical Industries the day before the Japanese chemical company publicly announced massive losses—which, in an earlier time, might have passed without comment, generated significant publicity and calls for action.²⁸

Of course, governments are hardly going to adopt insider trading prohibitions based upon the express rationale that if American rock-and-roll is good, so must be American style insider trading prohibitions. Moreover, a rationale that the government should make insider trading illegal because the conduct is unfair and immoral raises the question as to why, if that is the case, the law allowed the conduct for so many years. Hence, it is not surprising that the express rationale in many countries for making insider trading illegal looks to pragmatic economic considerations. Specifically, nations around the world have sought to increase the depth and liquidity of their local stock markets to match the sort of depth and liquidity found on the New York Stock Exchange.²⁹ The hope is that the broader investor base promoted by such markets would lower the cost of capital for local corporations, thereby aiding the ability of local corporations to compete in the global

24. *E.g.*, Akashi, *supra* note 22, at 1298-99.

25. Corporations Act, 1998, § 1002G(1) (Austl.).

26. *See, e.g.*, *Carpenter v. United States*, 484 U.S. 19 (1987) (involving leaking the contents of the Wall Street Journal's "Heard on the Street" column); *see also In re Ivan F. Boesky Securities Litigation*, 36 F.3d 255 (2d Cir. 1994) (involving the highly publicized insider trading by arbitrageur, Ivan Boesky).

27. *Wall Street* (20th Century Fox 1987).

28. *E.g.*, Akashi, *supra* note 22, at 1302-03.

29. *E.g.*, William Bratton & Joseph McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 236-37 (1999); Freis, *supra* note 20, at 27-28.

economy.³⁰ In addition, the highly visible corporate valuations provided by such markets, it is hoped, can serve to promote efficient management and resource allocation.³¹ Governments have come to believe that among the regulations necessary (for reasons I shall discuss later) for deep and liquid stock markets is a ban on at least some amount of trading on inside information.³²

III. VARIATIONS IN INSIDER TRADING PROHIBITIONS

So far, this paper has discussed insider trading prohibitions without being at all precise as to what conduct these laws prohibit. This is because insider trading prohibitions around the world differ as to when it is illegal for a party in possession of information unknown to the other side to buy or sell stock without first disclosing the information. As a sampling of this variation, Figure 1 provides a table comparing the insider trading prohibitions in the United States, under the EU Directive, in Australia, and in Japan.

30. See, e.g., Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 U.C.L.A. L. REV. 781, 832-34 (2001). Because stock exchange trading constitutes, for the most part, secondary trading rather than initial issuances by corporations seeking to raise money, the impact of deep and liquid stock markets on corporate cost of capital often is indirect. The liquidity provided by such markets makes a larger set of investors more willing to purchase stock in public offerings by corporations at a lower rate of return, thereby allowing corporations to sell their stock at a higher price. Moreover, the ability to sell stock in a public market following an initial public offering by the corporation is a critical factor in the willingness of venture capital firms to fund new and growing businesses prior to the businesses going public. *Id.* at 833.

31. Actually, underlying this point is an entire debate about the impact of stock market pressures on corporate governance. During the 1980s, when foreign companies seemed to be outperforming United States' corporations, it was popular to argue that pressures to maintain stock prices in public markets led to short-sighted management decisions. See, e.g., Bratton & McCahery, *supra* note 29, at 235 (1999). By the 1990s, when American firms seemed to be outperforming foreign companies, it became fashionable to argue that pressure to maintain stock prices in public markets served as an important discipline on inefficient management decisions. See, e.g., Jeffrey Gordon, *The Shaping Force of Corporate Law in the New Economic Order*, 31 U. RICH. L. REV. 1473, 1484-87 (1997).

32. E.g., Freis, *supra* note 20, at 30-31; Ruggiero, *supra* note 19, at 160-61; Karmel, *supra* note 21, at 1152; Akashi, *supra* note 22, at 1312.

FIGURE 1: COMPARISON OF INSIDER TRADING LAWS

	U.S.	E.U.	AUSTRALIA	JAPAN
TYPE OF INFORMATION	Non-public Material	Non-public Likely to affect price Precise Related to issuer or security	Non-public Material	Non-public Important facts
WHO COVERED	Traditional insiders Misappropriators Tippees, if tipper benefit	Primary insiders: a) directors b) shareholders c) access by employment, profession, duties Secondary insiders (Information directly or indirectly from primary insiders)	Anyone in possession of inside information	Corp-related parties Related to tender offeror Information direct from corp-related party
PROHIBITED ACTS	Trading or tipping for benefit	Primary: trading or tipping outside of normal business Secondary: trading	Trading or tipping	Trading
INTENT	Tippee, know or should know of breach	Full knowledge of facts	Know or ought to know that inside information (and that tippee is likely to trade)	Know

A. *Source of the Prohibition*

Before comparing the substance of various insider trading prohibitions, it is worth noting the difference in the source of the prohibition. The source of the prohibition contemplated by, and resulting from, the EU Directive, as well as in Australia, Japan, and, indeed, in most other countries outside the United States, is legislation specifically addressing insider trading.³³ By contrast, for the most part, the prohibition on insider trading in the United States results from administrative and judicial interpretations of a broad anti-fraud rule adopted by an administrative agency pursuant to authority under an even broader statutory provision. The difference between the ad hoc development of the United States' prohibition, and the enactment in other countries of specific legislation dealing with the issue, brings to mind Bismark's comment about laws and sausages—that, in both cases, public confidence might be better served if people saw only the end result rather than how the item was made.

It is sometimes said that the United States' insider trading prohibition goes back to the enactment of the 1934 Securities Exchange Act.³⁴ Such statements are misleading. True, Congress was concerned, among other things, with insider trading when enacting the 1934 Securities Exchange Act. The 1934 Act, however, did not prohibit anyone from trading on inside information. Instead, Congress included a provision (Section 16(b)) in the Act, which requires certain insiders (specifically, directors, officers, and owners of over ten percent of a class of the corporation's stock registered under the Act) to hand over to the corporation any profit they make on buying and then selling, or selling and then buying, stock in their company within a period of six months (so-called short-swing transactions). Hence, under the 1934 Act, anyone was free to trade on inside information, and even directors, officers, and more than ten percent shareholders could trade on inside information and keep their profits so long as they did not make an offsetting trade within six months.

Congress also included a provision (Section 10(b)) in the 1934 Securities Exchange Act, which makes it unlawful to employ, in connection with the purchase or sale of any security, any "manipulative or deceptive device or contrivance" in contravention of rules promulgated by the Securities Exchange Commission (SEC).³⁵ The idea behind Section 10(b) is to complement the specific requirements and prohibitions in the federal securities laws with a catch-all provision empowering the SEC to define and prohibit manipulative or deceptive conduct which otherwise might fall between the cracks in the statutory scheme.³⁶ Among the specific

33. See, e.g., Freis, *supra* note 20, at 40-41; Ruggiero, *supra* note 19, at 159; Karmel, *supra* note 21, at 1152-54; Akashi, *supra* note 22, at 1296-97.

34. E.g., Bhattacharya & Daouk, *supra* note 5, at 11.

35. The Securities Exchange Commission [hereinafter SEC or Commission] is the agency established by the 1934 Act to enforce the federal securities laws.

36. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

prohibitions the SEC has adopted pursuant to its authority under Section 10(b) is Rule 10b-5.

Rule 10b-5 has a rather modest origin. In 1942, the SEC's staff learned of an incident in which a corporation's president was going around lying to the corporation's shareholders in order to buy up stock on the cheap. The staff's problem was that the specific anti-fraud provisions of the federal securities laws were concerned with misrepresentations to sell securities, and did not prohibit deception in the course of purchasing securities. To close this gap, the staff proposed the SEC promulgate a new rule, Rule 10b-5, pursuant to the agency's authority under Section 10(b). In a nutshell, Rule 10b-5 makes it unlawful to commit fraud in connection with the purchase or sale of a security. The SEC, with little deliberation, adopted the staff's proposed new rule.³⁷

Nearly two decades passed before anyone applied Rule 10b-5 to trading on undisclosed inside information. In 1961, the SEC brought a disciplinary action, pursuant to its authority to regulate stock brokers, against the Cady, Roberts brokerage firm.³⁸ A broker in the Cady, Roberts firm received a tip from a corporate director—who was also associated with Cady, Roberts—that the corporation's board had just voted to cut the dividend, whereupon the brokerage firm was able to sell the firm's and the firm's clients' stock in the corporation before the corporation announced the board's decision to the public. The SEC held that the brokerage firm violated Rule 10b-5. A few years after *Cady, Roberts*, the SEC filed suit against various officials of Texas Gulf Sulfur Company to discipline their actions in trading on inside information.³⁹ These officials purchased stock in the corporation after the corporation made a major copper discovery, but before public disclosure of this discovery. The Court of Appeals for the Second Circuit held that this conduct violated Rule 10b-5.⁴⁰

There are a couple of points worth noting about these initial efforts to apply Rule 10b-5 to prohibit insider trading. To begin with, while it may offend national sensitivities to mention this, the French adoption of an insider trading prohibition in 1967 follows rather closely in time upon these U.S. developments.⁴¹ In addition, the scope of the United States' prohibition announced by the SEC and the Second Circuit was very broad. In fact, the thrust of the *Cady, Roberts* opinion was to respond to the brokerage firm's contention that, because the firm was not an insider, Rule 10b-5 did not prohibit the brokerage firm's trading without disclosure. The Commission rejected this argument by reasoning that the obligation to disclose arose from a relationship giving access to information intended only to be available for a

37. For a participant's recollection of how Rule 10b-5 came into being, see Milton Freeman, *Comments at the Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

38. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

39. See generally *SEC v. Texas Gulf Sulfur Co.*, 258 F.Supp. 262 (S.D.N.Y. 1966).

40. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 851 (2d Cir. 1968).

41. The District Court decision in *Texas Gulf Sulfur* came in 1966. See generally *Texas Gulf Sulfur Co.*, 258 F. Supp. 262 (1966).

corporate purpose rather than personal benefit, coupled with the unfairness of one party taking advantage of information which he or she knows is unavailable to those with whom he or she is dealing. Similarly, the Second Circuit in *Texas Gulf Sulfur* did not focus on the defendants' status as insiders in finding that they had a duty to disclose before trading. Rather, after expressing the view that the policy of Rule 10b-5 is to ensure all investors have relatively equal access to material information, the Second Circuit stated that "anyone in possession of material inside information" must disclose or abstain.⁴²

In decisions in 1980,⁴³ 1983,⁴⁴ and 1997,⁴⁵ the United States Supreme Court completely rewrote the law of insider trading under Rule 10b-5, shifting from the broad equal access approach of *Cady, Roberts* and *Texas Gulf Sulfur*, to a rather convoluted approach outlined in Figure 1. The Supreme Court's approach is the result of trying to import common law concepts of "fraud"⁴⁶ to reach results consistent with *Cady, Roberts* and *Texas Gulf Sulfur*—but inconsistent with either the way common law courts, for the most part, viewed insider trading,⁴⁷ or with the broad rationale of *Cady, Roberts* and *Texas Gulf Sulfur*. The result is a jurisprudence loaded with doctrinal inconsistencies and anomalies, a discussion of which is far beyond the scope of this paper.⁴⁸

B. *Type of Information*

Figure 1 begins with a category where the various insider trading prohibitions share an essential similarity. In every instance, the law limits the prohibition to situations in which the information possessed by the party trading is both non-public and significant. After all, unless one wishes to ban corporate insiders from holding stock in their companies, one cannot complain when insiders trade while in possession of information which is public knowledge or, if not known to the public, is trivial.

42. *Texas Gulf Sulfur Co.*, 401 F.2d at 848 (1968).

43. *Chiarella v. United States*, 445 U.S. 222 (1980).

44. *Dirks v. SEC*, 463 U.S. 646 (1983).

45. *United States v. O'Hagan*, 521 U.S. 642 (1997).

46. "Fraud" was a common law term long before its use in Rule 10b-5.

47. *See, e.g.*, Seligman, *supra* note 4, at 1102.

48. For a discussion of the inconsistencies and anomalies in the Supreme Court's insider trading decisions, *see, e.g.*, FRANKLIN GEVURTZ, CORPORATION LAW § 6.3a; Donald Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 ALA. L. REV. 399 (1988). This is not to suggest that the adoption of insider trading legislation in other countries represented a completely rational process without its own inconsistencies or anomalous reasoning. *See, e.g.*, Ruggiero, *supra* note 19, at 162 (decrying hasty adoption of insider trading legislation by the Italian Parliament as part of a package of laws designed to make Italian financial markets more like the United States). The difference may be that the ad hoc evolution simply makes all of the inconsistencies and anomalies more obvious.

Occasionally, questions arise about whether the information used in trading was non-public.⁴⁹ In fact, the Japanese and the European Union have followed some interesting approaches to the question of whether information is non-public. For example, the issue in Japan comes down to whether the corporation has made disclosure of the facts in question in accordance with criteria set forth in a Cabinet Ordinance, regardless of whether the investing public actually knows about the facts in question.⁵⁰ Also, the recitals of the EU Directive state that an analysis derived from publicly available data does not constitute non-public information.⁵¹

The much more frequent area of dispute, however, arises in determining when non-public information is significant enough to trigger the prohibition. One approach, which is followed in the United States and Australia, is to set out a broad standard for courts to apply as cases arise. In the United States, the information must be “material”—meaning that a reasonable investor would find the information important in deciding whether to buy or sell stock.⁵² Similarly, in Australia, the information must be such that a reasonable person would expect it to have a material effect on the price or value of the stock, or the information would be likely to influence investors in deciding whether to buy or sell the stock.⁵³ The problem with such a broad standard is that its application is highly fact sensitive and case specific, making it potentially more difficult to resolve litigation, and for insiders to decide whether they must disclose information before trading.⁵⁴ The EU Directive seemingly gives somewhat more guidance. The information must be precise, relate to the issuer of the traded security or to the security itself, and be likely to have a significant effect on the price of the traded security.⁵⁵

Japanese law attempts much greater specificity. The Japanese insider trading statute contains a laundry list of important facts that can trigger the insider trading prohibition.⁵⁶ These include: management decisions about issuing securities, reductions in capital, stock splits, alterations in dividends, mergers, purchases or sales in whole or in part of a business, dissolution, and marketing a new product; disasters or damages to the corporation; changes in principal shareholders; events

49. See, e.g., *SEC v. Texas Gulf Sulfur*, 401 F.2d 833, 846 (2d Cir. 1968) (involving a question as to whether sufficient time had passed after the corporation issued a press release, so that, when an insider traded, the released information was no longer non-public); *Leadenhall Australia Ltd. v. Peptech Ltd.*, 1999 NSW LEXIS 810 (finding alleged inside information to be a matter of public record, even if not known to the plaintiff).

50. E.g., *Akashi*, *supra* note 22, at 1317-18 (describing Japanese Cabinet Ordinance No. 321 of 1965, art. 30 (as amended by Cabinet Ordinance No. 23 of 1989)). In order to avoid applying the limited definition of public information to reach obviously silly results, however, the Japanese statute exempts trades solely among insiders and tippees from the prohibition of trading on inside information. SEL, *supra* note 22, art. 190-2(5)(7).

51. EU Directive, *supra* note 15, 13th Recital.

52. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

53. See, e.g., *Corporations Act, 1998*, §§ 1002C, 1002G(1)(a) (Austl.); *Ampolex, Ltd. v. Perpetual Trustee Co., Ltd.*, 1996 NSW LEXIS 2827.

54. See, e.g., *Basic*, 485 U.S. at 236 (noting the problem, but refusing to adjust the definition of materiality).

55. EU Directive, *supra* note 15, art. 1(1).

56. However, if the Ministry of Finance considers the facts too immaterial to affect investment decisions, the insider trading provision will not be triggered. SEL, *supra* note 22, art. 190-2(2).

causing delisting of a security; differences between actual and forecasted sales and profits; any other events listed by Cabinet Ordinance; and, finally, other important facts involving the management, business or assets of the corporation which would materially affect investment decisions.⁵⁷

The probable impact of these different formulations for the required significance of inside information may vary. For example, standards based upon whether a reasonable investor would consider a fact important in making buy and sell decisions, and standards based upon whether a fact would be likely to impact a stock's price significantly, should reach the same result. After all, by and large, investors find facts important because the fact might impact the stock's price, and if investors find a fact important in deciding whether to buy or sell, the investors' purchase and sale decisions will impact the stock's price.⁵⁸ By contrast, the difference between the Japanese list of important facts, and the various open-ended approaches, seemingly could produce a considerable impact on the scope of insider trading enforcement and activity. Yet, the Japanese law allows greater flexibility, while the United States' practice has created greater predictability than it might at first appear. Specifically, the Japanese statute contains an escape clause adding pretty much any other material facts to the list.⁵⁹ Conversely, enforcement actions in the United States have tended to focus on trading based upon advance knowledge of earnings reports and takeover activities to such an extent that one writer has suggested materiality for insider trading purposes in the United States has come to have an operational definition largely limited to these two types of information.⁶⁰

The EU Directive's guidelines that the information be precise, and relate to the issuer or the security, could have subtle, but nevertheless potentially significant, impacts when compared with results under the general materiality standard. The requirement that the information be precise stems from the French statute⁶¹ and is supposed to rule out mere rumors.⁶² The situation in the *Texas Gulf Sulfur* case discussed earlier illustrates a possible impact of this requirement. In *Texas Gulf Sulfur*, there were rumors circulating in the marketplace regarding a major copper find by the corporation. Various corporate insiders traded based upon their

57. *Id.* art. 190-2.

58. *See, e.g.,* Ampolex, Ltd. v. Perpetual Trustee Co., Ltd., 1996 NSW LEXIS 2827 (recognizing the interrelationship).

59. One must be careful, however, before making the facile assumption that the presence of this escape clause turns the Japanese statute into the equivalent of the American or Australian materiality approach. Such an interpretation would render the listing of specific types of important facts surplusage, and thus a court could be reticent about reaching such an interpretation. *Cf. People v. Jacques*, 456 Mich. 352, 572 N.W.2d 195 (1998) (holding that general terms in a statute, which follow a list of specific items, should be interpreted only to encompass items of the same kind as the specific items listed).

60. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J. L. & ECON. 149, 151 (1992).

61. *E.g.,* Donald Langevoort, *Defining Insider Trading: The Experience In Other Countries*, 6 No. 4 INSIGHTS 7, 9 (1992).

62. Commission Proposal for a Council Directive Coordinating Regulations on Insider Trading, art. 6, 1987 O.J. (C 153) 8.

knowledge of this find. It is easy to see that the geologist and other officials who were privy to the actual data regarding the exploratory drilling had precise information. On the other hand, as the information passed through various hands, presumably becoming all the more general, when did it pass from the realm of the precise to constitute a mere rumor? Under a materiality approach, assessing when distilled information is too vague and uncertain to form the basis for an insider trading violation asks a functional question: would a reasonable investor disregard the information? By contrast, the structure of EU Directive, referring both to precision and to likelihood of price impact, seems to demand an evaluation of the precision question independent of the likely impact on investors, and, hence, with no real world milestone for making the assessment.

The EU Directive's requirement that the information relate to the security in question,⁶³ or to the issuer of the security,⁶⁴ at first glance, seems without probable impact. After all, if the information did not relate to the company or its stock, why would anyone purchase or sell the stock based upon the information? Perhaps a government employee might trade based upon some sort of confidential general economic information to which he or she had access.⁶⁵ Here, the EU Directive and the United States' law would give very different results.

Alternatively, consider the situation which faced the United States Supreme Court in *Carpenter v. United States*.⁶⁶ *Carpenter* arose out of a scheme by a Wall Street Journal reporter and several of his friends to trade on their advance knowledge of the contents of the Journal's "Heard on the Street" column. While the information in the column was hardly non-public (being known to the Wall Street Journal), the publication of this column often impacted the price of stocks of corporations discussed in the column. Given this impact, knowledge of the Journal's future publication plans constituted material, non-public information.⁶⁷ By contrast, under the EU Directive, one would need to resolve the question of whether plans of a newspaper to discuss a stock or a corporation constitutes a fact which relates either to the stock or the issuing corporation.⁶⁸

63. Generally speaking, "security" refers to the traded stock, albeit the definition of "security" is broader than stock and can include debt securities and options. The EU Directive only reaches publicly traded securities, however. EU Directive, *supra* note 15, art. 1(2).

64. Generally speaking, the "issuer" of securities is the corporation.

65. *E.g.*, Ruggiero, *supra* note 19, at 183.

66. 484 U.S. 19 (1987).

67. *United States v. Carpenter*, 791 F.2d 1024, 1032 (2d Cir. 1986).

68. In answering this question, one must avoid arguing that the information relates to the stock because the information will impact the price of the stock. Such reasoning would make the relates language redundant of the part of the EU Directive's test which demands that the information be likely to have a significant impact on price of the stock.

C. *Who Is Subject to the Prohibition?*

When dealing with the type of information subject to the insider trading prohibition, the formulations may vary, but the essential idea is always the same. This is not true when it comes to who is subject to the insider trading prohibition. Here, one confronts different rules which result from varying views as to why it is unacceptable for some persons to buy or sell stock while in possession of information which the other party to the trade does not have.

One view of trading on inside information focuses on the information asymmetry as the fundamental evil. Under this view, entering a transaction when a person knows that the other side might not make the same agreement if the other side knew all the facts is considered unfair. After all, the basis for what is fair or moral is avoiding conduct toward others to which one would object if done toward oneself, and many persons feel cheated by non-disclosure of important facts. Moreover, from the standpoint of economic efficiency, the object is to promote transactions in which both sides feel better off for having made the deal based upon complete information. By contrast, transactions that simply shift wealth from an uninformed party to a well-informed party seemingly represent an inefficient zero-sum game. Indeed, the danger of becoming the victim of such a wealth transfer might make persons, who suspect themselves to be at an information disadvantage, less willing to invest. As discussed later in this paper, this decreased willingness to invest, in turn, could undermine the goal of promoting deep and liquid stock markets and a lower cost of capital.⁶⁹ At the extreme, this view of trading on inside information would seem to suggest a condemnation of any transaction in which one party possesses information unknown to the other side. No nation, however, follows such an equal information rule.

The problem is that information is both something of value to society and something which often takes work to produce. In order to encourage the production of information, presumably there must be some reward. This is why governments grant patents to inventors. An equal information rule could undermine the incentives to search for undiscovered values obtainable from buying or selling stock.⁷⁰ Moreover, given the moral undertone of the traditional work ethic, perhaps it is inconsistent with notions of fairness to suggest that individuals who work to produce information should not be required to share such information with others who could have worked to obtain the information for themselves.

On the other hand, suppose a person does not gain knowledge by working hard to gather information available to anyone who puts in the effort, but rather obtains the knowledge because of some superior access. For example, in order to carry out their jobs, corporate officers, directors, and even employees have access to

69. *Infra* Part IV.

70. E.g., Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 329-30.

information concerning the corporation, which is not available to outsiders. Alternatively, the superior access might consist simply of being in the right place at the right time to overhear a conversation.⁷¹ In this event, one could argue that there is no reason—either in terms of creating incentives for gathering information, or in terms of fairness toward those who work to obtain something others could have—to allow individuals to trade on the information without disclosing the information to those who lack access.⁷² This notion leads one toward the equal access rule adopted by *Cady, Roberts* and *Texas Gulf Sulfur*.

While the United States Supreme Court rejected the equal access approach in *Chiarella v. United States*,⁷³ Australia adopted an equal access rule in 1991. Specifically, before 1991, Australia's insider trading law only prohibited trading on inside information by those connected with the corporation whose stock they traded.⁷⁴ The 1991 revision extended the prohibition to reach any person who "possesses [material] information that is not generally available."⁷⁵

One problem with an equal access rule is defining when access is *unequal*. For example, the investment insights of one with superior analytical abilities might not be available to those less gifted no matter how hard they try. Similarly, the acquiring company's knowledge of its intent to make a premium price tender offer for stock in the target corporation reflects both facts open for discovery by anyone (whatever synergies or opportunities justify paying a premium price for control of the target), as well as a fact (the acquirer's subjective decision to make the offer) which is inaccessible to anyone outside of the acquiring company.

A nation which bases its insider trading law on an equal access philosophy has two mechanisms to deal with possible over-breadth or ambiguity in a simple-minded equal access rule. The mechanism followed by Australia's 1991 law is to create exceptions to its broad prohibition. For example, the Australian law allows trading without disclosure of one's own intentions (for example, to make a tender offer).⁷⁶

An alternate mechanism to deal with possible over-breadth or ambiguity in a simple-minded equal access rule is to confine the prohibition to the most common situations in which unequal access exists, and there is no justification for nevertheless allowing trading without disclosure. The EU Directive seems to provide an example of this alternative.⁷⁷ The EU Directive demands that member nations prohibit trading on non-public information by directors or shareholders (or

71. See *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

72. E.g., Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

73. 445 U.S. 222 (1980).

74. E.g., Karmel, *supra* note 21, at 1152.

75. Corporations Act, 1998, § 1002G(1), (2)(a) (Austl.).

76. *Id.* at § 1002P.

77. The EU Directive also avoids some possible overreach of an equal access rule by the definition of non-public information. As mentioned earlier, the recitals to the EU Directive state that an analysis of publicly available information is not non-public information.

the local equivalent); by those who obtain the information through their employment, profession or duties; and by those who obtain the information from persons in the prior categories.⁷⁸ These categories are likely to pick up the vast bulk of trades involving unequal access. Hence, it is plausible to conclude that the residual trades in which there is unequal access (and policy reasons do not dictate allowing the trade despite the unequal access) do not occur with sufficient frequency to justify the uncertainties generated by adopting a broad prohibition and making exceptions.

At first glance, the United States' prohibition appears similar to the EU Directive. This is not surprising. In *Chiarella*, the United States Supreme Court sought to uphold the result of *Cady, Roberts* and *Texas Gulf Sulfur*—both of which had followed an equal access philosophy to hold corporate insiders, and those who received tips from corporate insiders, liable for trading on inside information. Moreover, in holding that persons who misappropriate information from their employer or client can be liable for insider trading, the Supreme Court's opinion in *United States v. O'Hagan*⁷⁹ noted that the result would be consistent with the goal of the securities law to promote equal access to information among stock traders.⁸⁰ Nevertheless, the United States' insider trading prohibition ultimately is not a conscious attempt to prohibit trading in the most common situations in which there is unequal access to information. Rather, the United States' prohibition is based on a construct under which silence becomes the equivalent of a fraudulent misrepresentation, because the silence renders false certain implicit representations which arise in fiduciary relationships. This difference in the philosophical basis for the prohibition is not only of academic interest. Rather, it produces a number of substantive differences in the scope of the United States' and EU Directive's prohibitions.

The United States Supreme Court's efforts to delineate when trading on undisclosed inside information violates Rule 10b-5 began in the *Chiarella* decision mentioned above. *Chiarella* worked for a financial printing company. The printing company's customers included firms which were going to make tender offers to buy, at a premium price, outstanding stock of other corporations. Despite the customers having blanked out the names of the target corporations in the documents given to the printing company, *Chiarella* was able to figure out the identities of the target corporations from the surrounding material in the documents. He made around \$30,000 by purchasing stock in the target corporations prior to the announcements of the tender offers. Ultimately, the SEC uncovered *Chiarella's* trading, and *Chiarella* was convicted of criminally violating Section 10(b) and Rule 10b-5.

78. EU Directive, *supra* note 15, arts. 2(1), 4.

79. 521 U.S. 642 (1997).

80. *Id.* at 650-51.

Chiarella appealed all the way to the Supreme Court, which overturned the conviction.⁸¹

In order to understand the *Chiarella* decision, the actual holding of the case needs to be separated from the court's rationale, and from a critical issue which the court expressly left open. The holding of the case involves a jury instruction. The District Court judge instructed the jury that all they needed to find in order to convict Chiarella was, in purchasing the stock, that Chiarella used material non-public information at a time he knew other people trading in the securities market "did not have access to the same information."⁸² The actual holding in *Chiarella* was that this instruction was wrong—in other words, there is no equal access rule.

If mere possession of material information not accessible to other traders is insufficient to create a duty to refrain from buying or selling stock, then the inevitable question becomes what, if anything, can create such a duty? To answer this question, the Supreme Court in *Chiarella* came up with a rationale which a later Supreme Court opinion would refer to as the "traditional" or "classical" theory.⁸³ In the traditional or classical theory, the Supreme Court in *Chiarella* sought to reconcile the Court's holding with both *Cady, Roberts* and *Texas Gulf Sulfur*. To do so, the Supreme Court in *Chiarella* focused on the fact that the defendants in *Texas Gulf Sulfur* were directors, officers, and other employees (in popular parlance, "insiders") of the corporation whose stock the defendants purchased or sold, while, in *Cady, Roberts*, the broker had received a tip from such an insider. The significance of this fact, according to the Supreme Court in *Chiarella*, is that insiders have a fiduciary relationship—or a relationship of trust and confidence—with the shareholders of the corporation in which the insiders are directors, officers or employees. Under common law, a fiduciary relationship can make silence the equivalent of fraud because the relationship conveys an implicit representation that the fiduciary has disclosed material facts without needing to be asked.⁸⁴ Hence, according to the Court in *Chiarella*, a fiduciary relationship between the corporate insider and the party with whom the insider trades, creates a duty on the insider either to disclose material information before trading or to abstain from the trade.⁸⁵ Due to the fact that Chiarella was not an insider in the corporations whose stock he purchased (he was an employee of a printing company), nor had he received information from insiders of the corporations whose stock he purchased,⁸⁶ Chiarella had no duty under the traditional or classical theory.

So long as dealing with insiders, the traditional theory in *Chiarella* gets to the same point as an equal access approach or the EU Directive, although based upon

81. *Chiarella*, 445 U.S. at 225.

82. *Id.* at 231.

83. *See O'Hagan*, 521 U.S. 642 (1997).

84. *See, e.g.,* RESTATEMENT (SECOND) OF TORTS, § 551(2)(a).

85. *Chiarella*, 445 U.S. at 228-29.

86. The printing company's customers were the acquiring firms, and Chiarella bought stock in the target corporations. *See id.* at 224.

different reasoning. However, divergences in actual results appear as one moves beyond insiders. Consider, for example, persons who get information from insiders. Australia's equal access rule provides a simple result: a person who possesses material information which is not generally available cannot trade. The EU Directive is also fairly straightforward because it prohibits trading by so-called secondary insiders.⁸⁷ These are persons who possess information which could not have come other than directly or indirectly from a primary insider.⁸⁸ A primary insider, in turn, is a person who obtained information by virtue of being a director, shareholder, or through his or her employment, profession or duties.⁸⁹ Notice, the definition of secondary insiders not only picks up individuals who receive tips (in other words, information passed on for the purpose of the recipient's trading), but also persons who simply overhear a conversation by insiders. By contrast, the United States' approach gives a much more involved answer to the permissibility of trading by those who receive information from insiders. In large part, this answer comes from the Supreme Court's opinion in *Dirks v. SEC*.⁹⁰

Dirks arose out of a massive fraud at the Equity Funding company. Dirks was an investment analyst. A disgruntled ex-Equity Funding official, named Secrist, tipped Dirks off to the fraud in the hope that Dirks would expose the scheme. Dirks alerted his brokerage firm's clients to the fraud. The clients were then able to unload their Equity Funding stock prior to the fraud becoming public knowledge. The Securities Exchange Commission censured Dirks for violating Rule 10b-5 by tipping his firm's clients to the fraud so that the clients could sell prior to the information becoming public. Dirks appealed his censure ultimately to the Supreme Court, which overturned the SEC's action.⁹¹ The challenge for the Supreme Court in *Dirks* was to set out an approach which would reconcile finding a violation by the tippee in *Cady, Roberts*, with the notion that, under the traditional or classical theory, only insiders have a duty to disclose before trading.

One possible approach, which is used by the EU Directive, would be to say that anyone who obtains information from an insider picks up the insider's duty not to trade. This was the approach used by the SEC in censuring Dirks. The Supreme Court, however, rejected this sort of "tainted fruit" approach. Instead, the Supreme Court went back to a concept it had suggested in a footnote in *Chiarella*. This concept is that the tippee's liability flows from having acted as a "participant after the fact" in the insider's breach of duty not to trade on inside information without

87. To be technically accurate, the EU Directive does not, in itself, prohibit anything. As stated earlier, it requires member nations to prohibit inside trading within the guidelines of the directive—albeit, member nations can go beyond these guidelines in their prohibitions. With the reader's indulgence, however, this paper will refer to the EU Directive as prohibiting inside trading, instead of saying each time that the EU Directive commands member nations to prohibit insider trading.

88. EU Directive, *supra* note 15, art. 4.

89. *Id.* art. 2(1).

90. 463 U.S. 646 (1983).

91. *Id.* at 667.

disclosure.⁹² Specifically, the Supreme Court reasoned that an insider should not be able to accomplish indirectly what the insider could not legally do directly.⁹³ Hence, because allowing an insider to profit by trading on undisclosed inside information would be illegal, it should be illegal for the insider to profit by passing on information for another person's use in trading. This rationale, in turn, led the Supreme Court in *Dirks* to hold that trading by tippees violates Rule 10b-5 when, but only when, an insider breaches his or her duty by passing on the tip in order for the insider to obtain some personal benefit (as, for example, if the recipient of the information were to give the insider something in exchange for the tip).⁹⁴ In the Supreme Court's view, because Seicrist (the insider) received no personal benefit from passing on the information to Dirks, Dirks could not be liable for trading or advising his clients to trade on the information.⁹⁵

An even more significant difference between the United States' approach and the EU Directive existed before 1997. The difference involved individuals who obtained information from sources which did not trace back to the corporation whose stock they traded. As in *Chiarella*, this often involves tender offers, where individuals, like Chiarella, become aware of the intended offer through work on behalf of the firm planning to make the offer. Under the EU Directive, persons such as Chiarella are subject to the prohibition because they obtain the information by virtue of their employment, profession or duties. Under the traditional theory in the United States, such individuals could not be liable. As a reaction to the *Chiarella* decision, the SEC used its rulemaking authority under Section 14(e) of the Securities Exchange Act⁹⁶ to adopt Rule 14e-3(a). Rule 14e-3(a) makes it unlawful to trade on material information concerning a tender offer, when one knows, or has reason to know, that the information is non-public and comes from the acquiring company, the target company, insiders of such companies, or persons working on behalf of either company in connection with the tender offer.

More broadly, in 1997, the Supreme Court sided with a number of lower courts which had accepted a different theory of liability for persons like Chiarella. The government had advanced a theory known as the misappropriation theory as an alternate grounds for affirming the conviction in *Chiarella*, but the Supreme Court refused to address a theory which was not within the jury instruction. However, in *United States v. O'Hagan*,⁹⁷ the Supreme Court finally reached the issue. O'Hagan

92. *Chiarella*, 445 U.S. at 230 n.12.

93. *Dirks*, 463 U.S. at 662.

94. *Id.* at 666-67.

95. *Id.* The Supreme Court in *Dirks* also discussed persons, such as underwriters, accountants, lawyers and consultants, who receive information in confidence for a legitimate corporate purpose from insiders. The Court stated that such persons have the same obligations with respect to trading on information they receive from the corporation as do corporate officials. *Id.* at 655 n.14.

96. Section 14(e) makes it unlawful to engage in fraudulent conduct in connection with tender offers, and grants the SEC authority to promulgate rules reasonably designed to prevent such fraudulent conduct.

97. 521 U.S. 642 (1997).

was an attorney at a Minneapolis law firm. An English company (Grand Metropolitan) retained O'Hagan's firm to act as local counsel in connection with Grand Metropolitan's planned tender offer for the stock of a corporation (Pillsbury) headquartered in Minneapolis. While O'Hagan did no work on this matter, he learned of the tender offer from another attorney at the firm.⁹⁸ O'Hagan then purchased Pillsbury shares and options to buy Pillsbury shares, and, as a result, made a profit of over \$4 million after announcement of the tender offer. Upon the discovery of his trading by the SEC, O'Hagan was indicted and convicted of violating Section 10(b) and Rule 10b-5.⁹⁹

Upon appeal, the Supreme Court held that O'Hagan violated Rule 10b-5. The Supreme Court based the violation on O'Hagan's having misappropriated confidential information (the plans for a tender offer) from both his law firm and from the firm's client, Grand Metropolitan.¹⁰⁰ Reaching this result required the Supreme Court to find that misappropriating information can equal a fraud. The notion is that an individual, such as O'Hagan, who stands in a fiduciary relationship, expressly or implicitly represents to his or her employer or client that he or she will act loyally—in other words, that he or she will not embezzle money entrusted to his or her care, nor misuse information which his or her employer or client made available and does not wish disclosed or traded upon. If, without disclosing to the employer or client the fiduciary's subversive intention, the fiduciary then embezzles money or misuses information entrusted to the fiduciary, the fiduciary has lied in making this express or implicit representation of loyalty, and thereby has defrauded the employer or client.¹⁰¹

The misappropriation theory closes a considerable gap between United States' law and the EU Directive. Still, the different underlying bases and resulting boundaries of the misappropriation theory versus the provision in the EU Directive dealing with persons obtaining information through their employment, profession or duties, can produce different outcomes. In some instances, the misappropriation theory might have a broader reach. For example, it might be possible to misappropriate information in violation of express or implied representations of confidentiality made to relatives.¹⁰² Unless the relatives were primary insiders (or received their information from secondary insiders), the EU Directive presumably

98. Under the EU Directive, the fact that O'Hagan did not work on the transaction might make it uncertain whether he obtained the information by virtue of his employment, profession, or duties. *But see infra* note 105. The broad definition the EU Directive applies to secondary insiders would make it unnecessary to resolve this question.

99. O'Hagan was also convicted of violating Rule 14e-3, the federal mail fraud statute, and even federal money laundering statutes. *O'Hagan*, 521 U.S. at 649.

100. *Id.* at 653.

101. The Supreme Court also had to find that this fraud was "in connection with the purchase or sale of [a] security[ly]." *O'Hagan*, 521 U.S. at 653. Taking a literalist approach, the majority of justices in *O'Hagan* reasoned that because the very act by which O'Hagan misappropriated information was purchasing stock, the fraud (misappropriating the information by trading on it) was in connection with the purchase of a security. *Id.*

102. *E.g.*, *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); Rule 10b5-2.

would not reach information that comes from relatives communicating in a non-professional setting.¹⁰³ In other instances, the EU Directive can have a broader reach than the misappropriation theory. For example, in situations in which the employer does not care about trading by the employee, there would be no misappropriation.¹⁰⁴ The EU Directive, however, prohibits trading on any non-public information which comes from employment, regardless of the employer's attitude.¹⁰⁵

Japanese law stands at the opposite extreme from Australia, and is considerably narrower than the EU Directive or, in most respects, current United States' law. The Japanese prohibition reaches so-called corporate related parties. This includes directors, officers, employees, shareholders, as well as persons associated with a corporation through either a contract or a government supervisory role, who obtain material non-public information by virtue of their relationship with the company.¹⁰⁶ Such corporate related parties cannot trade, while in possession of material non-public information, stock of the corporation to which they have a relation,¹⁰⁷ or stock of another company which is subject to a planned tender offer by the corporation to which they have a relation.¹⁰⁸

Notice, the Japanese approach, to a great extent, parrots the United States' approach under the traditional theory, plus Rule 14e-3. There are, however, some differences. The traditional theory in the United States would not pick up individuals obtaining information through a government supervisory role, as does the Japanese prohibition. Moreover, individuals obtaining information by virtue of a contractual relationship with the corporation would not count as insiders of that corporation under *Dirks* unless there is an expectation that they will hold the information in confidence.¹⁰⁹ By contrast, under Japanese law, a contractual relation giving access to non-public information evidently is enough regardless of the expectation of confidentiality.¹¹⁰

There are bigger differences between United States and Japanese law with respect to trading by those who receive information from insiders (so-called tippees). Under Japanese law, persons receiving non-public information directly

103. Of course, typically, the relatives providing non-public information would either be primary insiders or have received their information, at least indirectly, from primary insiders, thereby making the trading relative liable as a secondary insider.

104. *E.g.*, Langevoort, *supra* note 61, at 408-09.

105. The EU Directive provision, which prohibits trading by persons who obtain information by virtue of their employment, profession or duties, came from the French law, where this language had received a broad interpretation. *See, e.g.*, Langevoort, *supra* note 61, at 8. *See also* Robert Irving, *French Insider Trading Law: A Survey*, 22 U. MIAMI INTER-AM. L. REV. 41, 62 (1991) (describing the 1976 conviction of an architect for violating the French insider trading prohibition, after the architect deduced that a joint venture was in the works from seeing a CEO, who had retained the architect's services, talking with the CEO of another company).

106. SEL, *supra* note 22, art. 190-2(1).

107. *Id.*

108. *Id.* art. 190-3.

109. *Dirks*, 463 U.S. at 655 n.14.

110. *See* SEL, *supra* note 22, art. 190-2(1)(4).

from corporate related parties are subject to the prohibition on trading.¹¹¹ Unlike the *Dirks* test in the United States, this does not depend upon a showing that the insider received a personal benefit by making the tip.¹¹² Yet, also unlike the United States' law¹¹³ (or the EU Directive), the Japanese prohibition only extends to a person who receives information directly from a corporate related party, and not to remote tippees. In other words, the prohibition does not extend to persons (like *Dirks*' clients) who received their information from another tippee, rather than the insider.¹¹⁴

Significantly, unlike current United States' law (as well as the EU Directive), Japanese law does not prohibit trading by persons who gain information through professional relationships other than with the corporation whose stock they trade, or with a corporation making a tender offer for the stock they trade.¹¹⁵ Of course, in many instances—such as when attorneys and financial advisors obtain non-public information through working on the personal behalf of insiders—traders who obtain information through professional relationships could be liable as tippees under the Japanese statute because Japanese law contains no equivalent to the personal benefit requirement under *Dirks*. Still, the facts in *Carpenter v. United States*¹¹⁶ illustrate the potential significance of Japan's failure to adopt the equivalent of either the United States' misappropriation theory or the EU Directive's approach to information obtained by virtue of one's employment, profession or duties. The Japanese statute would not have prohibited trading on the advance knowledge of the contents of a newspaper column, as occurred in *Carpenter*.

This raises the question of why the Japanese followed the approach laid out above. The similarity between the scope of the Japanese prohibition, and the scope of the United States Supreme Court's traditional theory, when coupled with Rule 14e-3, sounds hauntingly like my students' blind advocacy of following at least the broad outlines of United States' law. It is worth noting in this regard that at the time the Japanese enacted their insider trading provisions in 1988, the United States Supreme Court had not accepted the misappropriation theory—at least in the context of a securities law violation.¹¹⁷ Moreover, there appears to be a common thread to most of the Japanese departures from the traditional theory crafted by the United States Supreme Court. Rejecting *Dirks*' personal benefit requirement for liability from tipping, foreclosing liability for remote tippees, and treating persons who receive non-public information by virtue of a contract with the corporation as an

111. *Id.* art. 190-2(3).

112. *Id.*

113. *See, e.g.*, *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988) (holding remote tippees liable for violating Rule 10b-5).

114. *See SEL, supra* note 22, art. 190-2(3).

115. *See id.* art. 190-3.

116. *Carpenter*, 484 U.S. 19 (1987).

117. In *Carpenter*, the United States Supreme Court held that misappropriating information through stock trading violated the federal mail fraud statute. *Id.*

insider regardless of any expectation of confidentiality, all make litigation simpler.¹¹⁸ The Japanese treatment of traders who obtain information by virtue of a contract or a government supervisory role might also show the impact of events which precipitate legislation on the contents of the legislation. Specifically, the insider trading scandal which precipitated the Japanese legislation involved a bank's use of information gained in putting together a rescue package for a corporation which had incurred massive losses.¹¹⁹ On the other hand, the narrowness of the Japanese prohibition when compared to the United States' misappropriation theory and the EU Directive might appear to be the reaction of a government which was not sure how much it really wanted to enact an insider trading prohibition.

D. Prohibited Acts

It should go without saying that the basic prohibition common to all insider trading laws is that persons, who come within the prohibition, cannot buy or sell stock on the basis of significant non-public information, as defined by the relevant law.¹²⁰ One question raised by this basic prohibition is whether it is enough that the trader was in possession of inside information when he or she bought or sold stock, or whether the information actually must have played at least some role in motivating the decision to purchase or sell—in short, whether the violation depends upon use rather than just possession of inside information.¹²¹ In the United States, the circuit courts have split upon the use versus possession issue,¹²² leading the SEC to amend Rule 10b-5 to concede grudgingly that proof of non-use could preclude finding a violation.¹²³ The requirement of use, rather than mere knowledge, seems implicit in the EU Directive's prohibition of "taking advantage" of inside information by purchasing or selling stock.¹²⁴ By contrast, the Australian¹²⁵ and Japanese¹²⁶ statutes seem to prohibit trading by one in possession of material non-public information.

118. See, e.g., Akashi, *supra* note 22, at 1314 (stating that the purpose of limiting liability to the first tippee is to provide a bright line rule).

119. See *supra* text accompanying note 28 (describing the scandal).

120. Also, needless to say, this prohibition extends to setting up others to trade on the insider's behalf using significant non-public information. See, e.g., EU Directive, *supra* note 15, art. 3(b).

121. Typically, as in *Chiarella*, *Dirks* and *O'Hagan*, it is fairly obvious that the inside information motivated the defendant's trade. Occasionally, however, insiders might claim that they would have bought or sold the same amount of stock at the same time even if they did not know of the undisclosed inside information.

122. Compare *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), with *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993).

123. Rule 10b-5-1. While conceding that persons can avoid liability by showing that they did not use (or trade "on the basis of") inside information, Rule 10b-5-1 contains a fairly constrained list of facts—a contract, instructions, or a written plan for the trades, which the insider made before receipt of the information—which would make such a showing.

124. EU Directive, *supra* note 15, art. 2(1).

125. See Corporations Act, 1998, § 1002G(2) (Austl.).

126. See SEL, *supra* note 22, art. 190-2.

More significant variations among insider trading laws involve tipping. Not surprisingly, Australia has the broadest prohibition. The Australian statute prohibits communicating material non-public information to a person who one knows, or should know, will trade upon the information.¹²⁷ Also not surprisingly, Japan has the narrowest law. The Japanese statute does not prohibit tipping.¹²⁸ Instead, the only way in which the Japanese law deals with the problem is by punishing first-tier recipients of information who trade.¹²⁹ A variation on the fact pattern in the *Dirks* case illustrates the gaping hole this leaves in the Japanese insider trading prohibition. The Japanese law would not have penalized Dirks (who passed on the inside information to his clients, but did not trade himself), or Dirks' clients (who traded on the information, but were second-tier tippees), even if Secrist (the Equity Funding insider who alerted Dirks to the fraud) had sold Dirks the information, rather than alerting Dirks as a good deed.¹³⁰

United States' law and the EU Directive occupy middle ground on liability for tipping. Under *Dirks*, liability of the tipper, as well as the tippee, depends upon whether the tipper passed on the information for personal benefit.¹³¹ The EU Directive prohibits primary insiders (i.e., directors, shareholders, and other persons who gain information by virtue of their employment, profession or duties) from disclosing inside information to any person except if the "disclosure is made in the normal course of the exercise of [their] employment, profession or duties."¹³² The EU Directive, however, does not prohibit tipping by secondary insiders (i.e., those who receive information from primary insiders). Notice, this means that Dirks would not have violated the EU Directive's prohibition in passing on Secrist's tip to Dirks' clients because Dirks was a secondary insider.¹³³ Dirks' clients, however, were also secondary insiders (having received information indirectly from a primary insider), and under the EU Directive, could not legally trade.

127. Corporations Act, 1998, § 1002G(3) (Austl.).

128. *E.g.*, Akashi, *supra* note 22, at 1314. One caveat to this conclusion exists if the tipper solicited trading by the tippee or could be said to be the tippee's accomplice. *Id.*

129. *See supra* text accompanying notes 111-14.

130. The legislative history of the Japanese statute leaves open the possibility of treating some intermediate tippee-tippers as simply conduits, so that the ultimate trader becomes liable as a first-tier tippee. *E.g.*, Akashi, *supra* note 22, at 1314. This should prevent blatant efforts to take advantage of this gap in the Japanese statute by setting up dummy tippees, but it is questionable whether this would have applied to Dirks' role.

131. How this personal benefit test works in the event of multi-tier tipping is not entirely clear. *See, e.g.*, GEVURTZ, *supra* note 48.

132. EU Directive, *supra* note 15, art. 3(a).

133. While Dirks arguably received Secrist's tip in Dirks' professional role of investment analyst, thereby making Dirks a primary insider, under this interpretation of the facts, passing on the information to Dirks' clients would have been in the normal exercise of Dirks' profession.

E. Intent or Knowledge Requirement

When dealing with prohibitions, it is normal for the law to specify the intent or knowledge necessary to find a violation.¹³⁴ Knowledge is normally the important element of intent in the context of fraud—the law commonly distinguishing between the false statement which the speaker knows to be false and the false statement which the speaker mistakenly thought was true.¹³⁵ Hence, it is not surprising that the various insider trading prohibitions have requirements with respect to the intent or knowledge necessary to find a violation.

The EU Directive provides an example. It prohibits “taking advantage” of inside information “with full knowledge of the facts.”¹³⁶ This, however, raises the question as to what facts the trader must know. One fact the trader must know is the inside information itself. Indeed, it is difficult to understand how a person can “take advantage” of inside information without knowing inside information. Accordingly, unless the requirement that the trader “take advantage” of inside information “with full knowledge of the facts” is simply a redundancy,¹³⁷ there must be some other facts which the trader must know.

The Australian statute is better drafted to answer this question. It requires that the trader know (or reasonably ought to know) that the information was non-public and material.¹³⁸ Realistically, when dealing with trading by insiders of the corporation whose stock is traded, or other persons who obtain the information through their employment or the like, this rarely is going to create much of a factual issue. The context in which persons like Chiarella, O’Hagan, and the Texas Gulf Sulfur officials received their information, and their unseemly haste in acting on the information, would make laughable any claims that the parties thought the information was insignificant or already in the public domain.

More realistic concerns with a defendant’s knowledge come up in the context of tipping. For example, the person who passes on the information might not have realized that the recipient would trade upon the information.¹³⁹ Additionally, the recipient might not be fully aware of the insider status of the source, especially if the information has passed through several hands.¹⁴⁰ In such situations, knowledge requirements can become important. There are some interesting differences in the way in which the EU Directive and the Australian statute, as well as United States’

134. In Anglo-American criminal law, this is known as “mens rea.”

135. *E.g.*, *Derry v. Peek*, 14 A.C. 337 (H.L. 1889).

136. EU Directive, *supra* note 15, art. 2.

137. The reader having arrived at this point may have noticed that avoiding interpretations which render provisions redundant seems to be a constant problem with the formulations in EU Directive.

138. Corporations Act, 1998, § 1002G(1) (Austl.).

139. Indeed, sometimes the source of the information did not even intend to pass on the information (as, for instance, if the trader overheard a conversation).

140. *Cf.* *SEC v. Musella*, 678 F. Supp. 1060, 1062 (S.D.N.Y. 1988) (addressing the knowledge of remote tippees who consciously chose not to ask their tipper about the source of the information, which they evidently suspected).

and Japanese law, deal with these situations, which serve to illustrate several basic aspects of such knowledge requirements.

To begin with, differences in the scope of the prohibitions create differences in the knowledge requirements. For example, because Australia's statute generally prohibits anyone with material non-public information from trading, without regard to the source of the information, all the trader must know is that the information is material and non-public. The fact that the trader was unaware of the ultimate source of the information would only be relevant insofar as this ignorance might bear upon whether the trader was unaware that the information was non-public. By contrast, under the EU Directive, because secondary insiders are only liable if the information they act on came directly or indirectly from primary insiders, the secondary insider's lack of knowledge of the source of the information could preclude finding a violation.¹⁴¹ The legislative history of the Japanese statute similarly indicates that the tippee must know that the information came from a corporate related party, as well as that the information is material and non-disclosed.¹⁴² Under the United States Supreme Court's opinion in *Dirks*, the recipient must not only know of the source of the information, but must also realize that the tipper was passing on the information for personal benefit.¹⁴³

Next, these statutes illustrate different attitudes toward persons who are negligent in failing to realize that they were trading on material non-public information (which, if necessary to a violation under the statute, came from an insider). As previously noted, the EU Directive requires "full knowledge of the facts."¹⁴⁴ The legislative history of the Japanese statute similarly suggests that actual knowledge is required.¹⁴⁵ By contrast, as stated above, Australia's statute requires that the trader knew, or reasonably ought to have known, that the information was material and non-public. Curiously, the United States' law is unclear on this issue. In *Ernst & Ernst v. Hochfelder*,¹⁴⁶ the United States Supreme Court held that violations under Rule 10b-5 require scienter.¹⁴⁷ In *Dirks*, however, the Supreme Court stated that liability of a tippee depends upon whether the tippee knew "or should know" of the tipper's breach of duty in passing on the information.¹⁴⁸

141. While trading by secondary insiders only violates the EU Directive if done with "full knowledge of the facts," showing that the secondary insider knew the exact source of the information might not be necessary. Secondary insider status results from possessing information, "the direct or indirect source of which could not be other than" a primary insider. EU Directive, *supra* note 15, art. 4. Thus, the only fact the trader might need to have full knowledge of is that the information must have originated with an inside source, even if the trader does not know who this source was.

142. *E.g.*, Akashi, *supra* note 22, at 1314.

143. *Dirks*, 463 U.S. at 651.

144. EU Directive, *supra* note 15, art. 4.

145. *E.g.*, Akashi, *supra* note 22, at 1314. Curiously, the Japanese statute itself does not address the issue of knowledge or intent.

146. 425 U.S. 185 (1976).

147. "Scienter" traditionally refers to knowing, or at least reckless disregard of the facts.

148. *Dirks*, 463 U.S. at 660.

Finally, the EU Directive, the Australian statute, and United States' law each illustrate different ways of using the knowledge or intent element to differentiate between legitimate and illegitimate disclosure of information.¹⁴⁹ Naturally, any law that penalizes the source of inside information for trading done by the recipient of the information must avoid prohibiting disclosures for legitimate purposes. For example, the law should not penalize a partner in a law firm who, as part of a discussion of firm business, discloses to his fellow partner that the firm is representing a company planning to make a tender offer for a local corporation, simply because the other partner then runs off and buys stock in the target corporation.¹⁵⁰ One approach is to determine whether the disclosure was done for a legitimate purpose, and to penalize any disclosure leading to trading if the disclosure was not for such a purpose. The EU Directive takes this approach, prohibiting, as mentioned earlier, any disclosure of inside information unless made in the normal course of employment, profession or duties. Australia and the United States take the opposite approach. Instead of asking if there was a legitimate purpose for the disclosure, Australian and United States' law focus on whether there was an illegitimate purpose. Specifically, under *Dirks*, the test in the United States is whether the insider passed on the information for trading in order to obtain some personal benefit.¹⁵¹ Australia, not surprisingly, takes a more expansive view. Under Australian law, the issue is whether the person disclosing the information knew, or should have known, that the recipient would trade upon the information.¹⁵²

IV. WILL INSIDER TRADING PROHIBITIONS ACHIEVE THE GOALS OF THE NATIONS ADOPTING THE PROHIBITIONS?

Whether insider trading prohibitions will achieve the goals of the nations adopting the prohibitions depends, in the first instance, upon the goal which motivated the statute. In some instances, the only real objective of the insider trading law might be simply to have such a law, in which event, the law, by its very existence, achieves its objective. The insider trading laws of some European Community member nations, who must adopt prohibitions in order to comply with the EU Directive, might illustrate this. More broadly, as suggested in Part II of this paper, many nations may have adopted insider trading prohibitions simply because the United States, and a growing number of other nations, have such laws.

149. The issue does not arise under Japanese law because Japanese law does not prohibit tipping.

150. Essentially, these were the facts in *O'Hagan*.

151. *Dirks*, 463 U.S. at 659.

152. See *supra* note 127 and accompanying text.

An alternate goal of such laws might be to combat a practice which nations have come to believe is unacceptable as a matter of fairness and business morality.¹⁵³ In this event, whether insider trading laws achieve their objective depends upon how one measures success. By one measure, the mere enactment of the prohibition might achieve the objective, at least in some part, because it expresses society's disapproval of the conduct. Typically, however, success of a legal prohibition directed at combating morally unacceptable conduct tends to be measured by the extent to which the prohibition decreases the extent of the conduct. Such a decrease might occur by virtue of the deterrence resulting from enforcement of the prohibition, or because the existence of the prohibition could change attitudes toward engaging in the conduct. Unfortunately, unlike homicides, robberies, and other commonly reported crimes, there are no regularly reported statistics on illegal insider trading.

Anecdotal evidence suggests that insider trading has remained prevalent in many countries despite passage of laws outlawing the practice.¹⁵⁴ Of course, this sort of evidence is subject to criticism on two counts. To begin with, as comparisons of citizen perceptions of crime versus actual crime statistics have shown, perceptions as to the extent of various illegal activities can often significantly diverge from reality.¹⁵⁵ Moreover, even if insider trading remains prevalent after enactment of a prohibition, this does not mean that the practice would not be even more prevalent without enactment of the prohibition.

There also have been attempts to measure more scientifically the impact of insider trading laws on the prevalence of insider trading. These studies suggest that the insider trading prohibition in the United States may have shifted the nature of trading on inside information, but not necessarily decreased the overall extent of such trading. For example, a 1992 study of publicly reported insider trades in the United States¹⁵⁶ by Professor Seyhun found that insiders overall outperformed the market in their trades; in other words, generally, insiders were able to sell their stock before bad news and purchase stock before good news.¹⁵⁷ Moreover, the ability of insiders to achieve above-market profits on their trades actually rose after enactment

153. *E.g.*, Nasser, *supra* note 4, at 377. Whether nations should view insider trading as unacceptable as a matter of fairness and business morality raises an interesting question as to the transferability of business ethics norms between different cultures. This is not to say that some cultures accept less ethical conduct, but rather that culture specific factors might dictate whether conduct should be viewed as ethical. For example, non-disclosure of material facts becomes deceptive (and hence unethical) if there is a general expectation that persons will disclose without having to be asked. If expectations are different, then there is no deception.

154. *Id.* at 382-84 (stating that business persons report that insider trading remains prevalent in Japan, despite the 1988 enactment of a prohibition on the conduct); Bratton & McCahery, *supra* note 29, at 270 (explaining that the German insider trading law is thought to have done little to alter the trading practices of insiders).

155. *See, e.g.*, Wendy Simmons, *About Half of Americans Still Say There is More Crime in the Country Now Than a Year Ago*, at <http://www.gallup.com/poll/releases/pr000907.asp> (last visited Sept. 7, 2001) (copy on file with *The Transnational Lawyer*).

156. Keep in mind that there is nothing illegal about insiders buying and selling stock in their corporations; the prohibition is upon making such trades based upon non-public material information.

157. *See generally* Seyhun, *supra* note 60.

of a 1984 amendment to the Securities Exchange Act, which increased the penalties for illegal insider trading.¹⁵⁸ Professor Seyhun suggests that the explanation for the results in his study lies in the increasing predictability of enforcement actions for illegal insider trading in the United States. Specifically, once it became clear that enforcement actions in the United States largely focus on trading in advance of takeovers and earnings announcements, insiders were able to exploit their informational advantages in other areas with relatively little fear of prosecution.¹⁵⁹ Notice, this suggests that the greater the specificity of what facts fall within the insider trading prohibition—as, in the most extreme case, is found under the Japanese law—the less the law will deter insiders from exploiting their overall informational advantage. A recent study suggests that there is another way in which insiders exploit their informational advantages while avoiding prosecution for illegal insider trading.¹⁶⁰ This is to trade well in advance of earnings announcements and other events which cause the stock price to change direction significantly.¹⁶¹

Determining whether insider trading prohibitions will achieve the economic goal of promoting deep and liquid stock markets and a lower cost of capital is a much more complex question. As suggested earlier, the rationale behind this objective is that individuals who feel at risk of being taken advantage of by persons with inside information will be less likely to invest in stock.¹⁶² Decrease the risk to outside investors by enacting insider trading laws, the corollary goes, and outsiders should become more willing to buy and sell stock, thereby promoting deep and liquid stock markets. Nevertheless, there are a number of problems with this simple logic.

To begin with, one might question the extent to which persons really are less willing to invest in stocks because of the fear of insider trading. As stated above, it appears that considerable trading on inside information goes on in the United States despite the United States' insider trading law. Nevertheless, large numbers of Americans invest in stock. Indeed, as mentioned at the outset of this paper, the

158. Exch. Act § 21A. Professor Seyhun found that a 1988 amendment increasing penalties for illegal insider trading had no impact the ability of insiders to make above-market profits. Incidentally, despite acting twice to increase penalties for insider trading which violates Rule 10b-5, Congress refused to involve itself in deciding when, if ever, trading on inside information should violate the law.

159. Seyhun, *supra* note 60, at 176-77. Of course, Professor Seyhun is assuming that the most likely explanation for consistent above-market returns for insiders lies in their exploitation of an informational advantage resulting from their positions. This would seem to be a fair inference in the absence of any other systemic difference between insiders and other market participants.

160. Bin Ke, Steven Huddart & Kathy Petroni, *What Insiders Know About Future Earnings and How They Use It: Evidence From Insider Trades* (copy of working paper on file with *The Transnational Lawyer*).

161. Just as few storms appear without some telltale warning—a shift in the wind, a drop in barometric pressure—events such as a decline in corporate earnings might not often appear without any warnings detectable by corporate insiders. The problem from a practical enforcement standpoint is proving the existence of such warning signs and arguing over when these portents reach the level of materiality. Notice, incidentally, this pattern of insiders moving their trading earlier shows a significant problem with the EU Directive. Specifically, limiting the prohibition to trading on information which is “precise” allows insiders substantial room to exploit their informational advantages by trading on the early warning signs of significant corporate events.

162. *E.g.*, *United States v. O’Hagan*, 521 U.S. 642 (1997); EU Directive, *supra* note 15, Recitals 4-6.

United States' stock exchanges provide the model of deep and liquid markets to which the rest of the world aspires.

There are several possible explanations for the evident widespread willingness of Americans to invest in stock despite the evident widespread trading on inside information in the United States. From the perspective of a critic of insider trading laws, an explanation would be that investors do not really care about others trading on inside information. For example, if the ability to trade on inside information gave corporate managers an incentive for making better business decisions (because managers could profit by purchasing stock in advance of public disclosure of good news), then the added return due to better corporate performance might more than offset the occasional loss from being on the wrong end of an insider trade.¹⁶³

There is another possible explanation for the willingness of numerous Americans to invest in stock despite widespread trading on inside information. Specifically, what determines the willingness of individuals to invest is not how much trading on inside information actually goes on, but rather how much of such trading prospective investors *think* is going on. In other words, an insider trading prohibition can succeed in its purpose of encouraging investment if the prohibition creates the perception that there is less trading on inside information. An important corollary to this observation is that an insider trading prohibition can fail to increase investor confidence if the perception is that trading on inside information remains widespread despite the prohibition. Hence, for this purpose, anecdotal evidence concerning the extent of insider trading actually can provide the more important measure of success than does a scientific study.

There is yet other answer to the conundrum of widespread stock ownership by Americans at the same time, one suspects, many Americans believe that trading on inside information is widespread.¹⁶⁴ It is an oversimplification to suggest that people will not invest in stock if they fear becoming the victim of another person's trading on inside information. After all, the return from investing in stock, even when facing the risk of occasionally being on the wrong end of a trade based upon inside information, might still be superior to the return on other available investments. Notice, however, this means that rational investors should demand a higher rate of return when investing in stock, in order to compensate for the risk of being on the

163. *E.g.*, MANNE, *supra* note 10, at 131-41. One obvious problem with this argument is that insider trading also allows managers to sell out their shareholdings without suffering the loss resulting from their bad decisions (or even to profit from bad decisions by taking short positions). Another argument as to why the overall group of investors might figure that insider trading does them more good than harm is that it moves the price of stock to reflect undisclosed information—up to reflect undisclosed good news and down to reflect undisclosed bad news—with the result that most traders face less risk from inaccurate pricing when purchasing or selling stock. *Id.* at 77-91. Of course, promoting earlier public disclosure would seem to better accomplish this result.

164. Every year, in discussing the policies behind the insider trading prohibition, I take an informal poll of my Business Associations students. I ask how many of them believe that widespread trading on inside information occurs in American stock markets. Invariably, the vast majority of hands go up. I then ask how many of them, if they had money to invest, would buy some stocks. Again, the vast majority of hands (including pretty much all those who gave an affirmative answer to the first question) will go up.

wrong end of a trade based upon inside information. Indeed, there is some empirical evidence that this happens.¹⁶⁵ Hence, enacting an insider trading prohibition might be expected to decrease corporations' cost of capital—assuming investors perceive the prohibition to decrease the incidence of trading on inside information—even though investors still will buy stock in the absence of such a prohibition.

The concern that individuals will cease to invest in corporate businesses because of fear of insider trading is oversimplified in another important manner. One way to reduce the risk of being on the wrong end of an insider trade is to become an insider. For instance, individuals or institutions holding substantial percentages of a corporation's outstanding stock (so-called large blockholders) often have the clout to obtain access to corporate information (perhaps through a seat on the board).¹⁶⁶ Accordingly, worries about insider trading would seem more salient to the small investor than to the large blockholder. Moreover, small investors often end up putting their money to work in corporations even if the small investors do not buy stock. For example, small investors worried about insider trading can put their money into a bank. The bank, in turn, can use its depositors' money to finance corporations through loans or, if allowed under the jurisdiction's banking laws, by taking equity positions. This analysis suggests that the fear of insider trading may not reduce the total financing available to corporations, nor even necessarily lead investors to demand a higher return on stock purchases. Instead, the fear of insider trading might serve to promote large block holdings in corporations, with small investors putting their money only indirectly into corporate businesses.

This discussion of the differential impact of insider trading on large blockholders and small investors has a couple of implications. To begin with, it might help explain why German banks were a major source of the opposition to adoption of Germany's insider trading law. More fundamentally, this differential impact brings into focus the relationship between insider trading and broader issues of comparative corporate governance and finance. Specifically, much recent scholarship in corporate governance and finance has focused on the fact that large blockholders commonly dominate the ownership of major corporations outside the United States; in other words, a relatively small number of institutions or individuals commonly own a majority of any given foreign corporation's stock.¹⁶⁷ By contrast, ownership of major corporations in the United States is typically highly dispersed so that no one investor has more than a small fraction of the outstanding shares.¹⁶⁸ To the extent that dominance by large blockholders is more efficient than widely

165. Harold Demsetz, *Corporate Control, Insider Trading and Rates of Return*, 76 AMER. ECON. REV. 313 (1986) (finding that the stock market tends to discount the stocks of corporations whose insiders trade heavily).

166. *See, e.g.*, Bratton & McCahery, *supra* note 29, at 226, 261. The notion that large blockholders typically have access to inside information is the basis for Section 16(b) of the 1934 Securities Exchange Act, subjecting 10% shareholders to forfeiture of profits on short swing trades.

167. *See, e.g., id.* at 218, 224-25; *see also* Mark Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 542, 562 (2000).

168. *Id.* at 541.

dispersed ownership, or, without respect to efficiency, a variety of intractable forces will preserve large blockholder dominance in non-American corporations, then it could be undesirable or futile to prohibit insider trading outside the United States in the hope that this will increase direct ownership of stock by small investors. While this paper is not a suitable forum for a full discussion of the efficiency or inevitability of large blockholder dominance in non-American corporations, a brief introduction should clarify the issues at stake.

The argument that large blockholder dominance can lead to more efficient management than widely dispersed shareholders reflects an observation known as the “Berle-Means thesis.” This observation is that widely dispersed shareholders lack the practical ability to control the corporation, with the result that management in such a corporation is largely accountable only to itself.¹⁶⁹ By contrast, if relatively few institutions or individuals own a substantial portion of the corporation’s outstanding stock, then persons with an economic stake in maximizing corporate profits have the practical power to keep tabs on management.

In light of the possible efficiencies of large blockholder dominance, one wonders why many nations have felt the need to pass insider trading laws, as well as taking a variety of other steps,¹⁷⁰ with the express goal of encouraging direct stock ownership by small investors. In fact, recent years have shaken the notion that large blockholder dominance is a more efficient way to run a corporation. As noted earlier,¹⁷¹ in large part, this reflects the comparative economic performance of the Japanese, European and United States’ economies during the 1990s. On a more sophisticated level, there are some empirical studies and theoretical literature which suggests (but, by no means conclusively demonstrates) that economies built around corporations with widely dispersed shareholders and with stocks traded in deep and liquid securities markets may perform better than economies built around corporations dominated by large blockholders and with financing largely coming from banks and internal sources.¹⁷²

169. ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

170. See e.g., Bratton & McCahery, *supra* note 29, at 236-37 (describing Italian, Japanese and French reforms); see generally Freis, *supra* note 20 (describing financial market reforms in Germany).

171. See *supra* note 31 and accompanying text.

172. E.g., Black, *supra* note 30, at 831-38. Professor Black lists a number of difficulties in relying on financing from banks and major shareholders rather than from strong securities markets. For example, economic downturns produce problem loans for banks. This, in turn, leads to credit becoming unavailable to corporations relying on bank financing. In addition, during downturns, large blockholders often send good money after bad to prop up weak subsidiaries. Moreover, self dealing by large blockholders often can turn into outright looting in difficult economic times, which, in turn, can magnify the economic downturn. Accordingly, Professor Black thinks it is not coincidental that the East Asian countries which best survived the 1997-1998 Asian financial crisis either had relatively strong stock markets or else a mostly closed economy. On the positive side, strong securities markets can attract foreign investors to spur local growth, and permit venture capital investor support of new enterprises (by allowing venture capital firms to cash out through initial public offerings).

Even if large blockholder dominance is not more efficient as a general proposition, there may be various reasons why such dominance is not likely to change for non-American corporations. If so, then prohibiting insider trading might not fundamentally increase the amount of direct stock holdings by small investors. For example, a recent article contains an argument that large blockholder dominance is a natural reaction to pro-labor policies of social democracies because blockholders can exercise some check on managers' tendencies to pursue labor friendly practices at the expense of shareholder profits.¹⁷³ Others have argued that large blockholder dominance is the result of weak corporate law protections for minority shareholders.¹⁷⁴ For example, the risk that insiders will exploit their positions through unfair self-dealing transactions with the corporation, if not deterred by a nation's corporation laws, might chill share ownership by small investors, or lead them to demand a higher rate of return to compensate for the risk. Interestingly, among the insiders who might exploit shareholders with small holdings, either by trading on inside information, or by entering unfair transactions with the corporation, are large blockholders. This fact has led Professors Bratton and McCahery to argue that prohibitions on insider trading in nations with large blockholder dominance might only lead to more self-dealing by such large blockholders, with the result that small investors still shy away from owning stock.¹⁷⁵

Ultimately, however, the question of whether insider trading prohibitions will promote deep and liquid markets, and decrease the cost of capital, should yield an empirical answer. A recent study by Professors Bhattacharya and Daouk¹⁷⁶ suggests that there is some positive news in this regard. By using four sets of available statistics, which the two professors contend can serve as surrogates for the cost of capital in a nation, Professors Bhattacharya and Daouk examined whether insider trading laws decreased the cost of capital in the nations around the world that have enacted such laws.¹⁷⁷ They found that the enactment of insider trading prohibitions produced no statistically significant impact.¹⁷⁸ However, they also found that a statistically significant improvement in the cost of capital in a nation occurred after the first prosecution took place under the nation's insider trading laws.¹⁷⁹ In other

173. Roe, *supra* note 167, at 595.

174. E.g., John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1999).

175. Bratton & McCahery, *supra* note 29, at 294-95. Of course, one might respond that an insider trading prohibition should be part of a range of measures designed to protect small shareholders and thereby encourage highly dispersed shareholdings. Professors Bratton and McCahery argue, however, that the ability to self-deal or trade on inside information might provide the necessary reward for large block holders to maintain their positions (rather than reducing their risks through diversification). *Id.* at 293-97. Hence, the issue might come back to the question as to whether large blockholder dominance is efficient and therefore worth preserving.

176. See Bhattacharya & Daouk, *supra* note 5.

177. *Id.* at 7.

178. *Id.* at 44.

179. *Id.* at 42.

words, while mere enactment of insider trading laws apparently produces no impact on investor confidence, efforts to enforce the law do.

V. CONCLUSION: LESSONS FOR THE UNITED STATES

One advantage often touted for federalism in the United States is that different laws among different states can serve as a laboratory to test the impact of different legal rules. The nationalization of the insider trading prohibition in the United States through Rule 10b-5 has pretty well drowned out experimentation involving different insider trading laws within the United States. In the absence of domestic experimentation, it is useful to see what insights the United States can gain from the experiences of other nations that have enacted insider trading laws that follow different statutory formulations and philosophies.

One lesson for the United States could come from the results of Professors Bhattacharya's and Daouk's study suggesting that enforcement of insider trading prohibitions lowers the cost of capital. Such results, if confirmed by further analysis, could provide a strong response to critics of insider trading prohibitions. One interesting possibility for additional empirical research along this sort of line would be to see if there are different impacts on the cost of capital depending upon the variations in the insider trading prohibition. In any event, there is an interesting implication to Professors Bhattacharya's and Daouk's conclusion that enforcement, rather than mere enactment, of insider trading prohibitions produces an impact on the cost of capital. This suggests that resources devoted to enforcement might be more important than the formulation of the legal prohibition.¹⁸⁰ There is one important caveat to this suggestion. To the extent that the formulation makes convictions difficult, or, as suggested by studies in the United States, simply shifts trading on inside information into more subtle forms, then one might expect less impact on lowering the cost of capital.¹⁸¹

Another lesson for the United States could come from the different statutory formulations used abroad. If Congress or the SEC ever decide to draft a specific insider trading prohibition, rather than punt to the courts' interpretation of Rule 10b-5, the formulations found in other nations' insider trading prohibitions (such as the

180. In this regard, a comparison of the enforcement and penalty provisions of various insider trading prohibitions arguably would be more useful than Figure 1's comparison of the substantive scope of the prohibitions. Professor Seyhun's study, however, suggests that increasing the size of the penalty will not decrease trading on inside information unless the substantive scope of the prohibition, and the enforcement of the prohibition, create a real risk that trading on inside information will result in imposition of a penalty. Moreover, a comparison of the formal enforcement provisions of the insider trading laws tells one little regarding the resources, sophistication and zeal of the agency charged with enforcement of the statute. *See, e.g.*, Black, *supra* note 30, at 807, 811 (discussing the resources, sophistication and commitment it takes to enforce laws against self-dealing in general, and insider trading in particular).

181. In fact, the rationale behind Australia's expansion of its prohibition to an equal access approach was that the prior laws had been difficult to enforce and, hence, trading on inside information had not been deterred. *E.g.*, Karmel, *supra* note 21, at 1152.

EU Directive) could provide examples of possible clarifying language, as well as examples of poor drafting to avoid. More broadly, Australia's experience with an equal access rule might prove that from a policy perspective, there may have been no reason for the Supreme Court to reject the equal access approach in *Chiarella*.

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