

## TURNING INSIDER TRADING INSIDE OUT IN THE EUROPEAN UNION

### INTRODUCTION

Ineffective insider trading rules represent one of the most significant roadblocks for United States investment in most European securities markets.<sup>1</sup> Several proposals have framed a solution by calling for the complete symmetry between United States and European securities markets.<sup>2</sup> Less than twenty years ago, the United States' harsh insider trading<sup>3</sup> laws were

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1. See generally Sam S. Miller, *Regulating Financial Services in the United Kingdom—An American Perspective*, 44 BUS. LAW. 323 (1989); Stephen J. Leacock, *In Search of a Giant Leap: Curtailing Insider Trading in International Securities Markets by the Reform of Insider Trading Laws Under the European Union Council Directive 89/592*, 3 TULSA J. COMP. & INT'L L. 51 (1995) (it took Germany two years to comply with the European Union Insider Trading Directive). Compare Eugenio Ruggiero, *The Regulation of Insider Trading in Italy*, 22 BROOK. J. INT'L L. 157 (1996) (arguing that although Italy's Insider Trading Act of 1991 imposes criminal sanctions against defendants even when no insider trading takes place, the Act has not been effective because Italian courts have yet to interpret or apply it), with *Not So Simple (Newly Created Financial Institution in Italy Will Act as a Stockbroker and a Fund Manager)*, ECONOMIST, July 6, 1991, at 85 (discussing how Italy is one of the most visible examples of a stock market dominated by insiders); Christine A. McGuiness, Note, *Toward the Unification of European Capital Markets: The EEC's Proposed Directive on Insider Trading*, 11 FORDHAM INT'L L.J. 432 (1988) (discussing the proposed insider trading regulations in the Netherlands, Belgium and Ireland).

2. See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997). "The SEC has identified 'harmonization,' or the minimization of differences between regulatory systems, as a central goal for international securities markets." *Id.*

3. See ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 810-11 (6th ed. 1998). An officer or director of a corporation may have knowledge about corporate affairs which will affect the price or value of the corporate shares before it becomes known to the general public or to other shareholders. As a result, the director or officer may be tempted to make a personal profit by either purchasing or selling shares without disclosing the information. Such trading is called "insider trading." See *id.* Rule 10b-5, promulgated under Section 10(b) of the Securities and Exchange Act of 1934 is the source of most current principles relating to transactions in securities by officers, directors and others. Rule 10b-5 was originally promulgated because the express anti-fraud remedy sections of the federal securities laws applied only to buyers of securities and the SEC wished to extend remedies to sellers of shares. See *id.* Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material

rather exceptional. However, today, a growing number of countries in the European Union (EU)<sup>4</sup> have adopted laws to remedy insider trading, originally at the behest of the Securities and Exchange Commission (SEC)<sup>5</sup> and today, largely under the auspices of the European Union's Council Directive 89/592 (EU Directive).<sup>6</sup> Adopted in 1989, the EU Directive mandated member states to enact insider trading legislation that met or exceeded certain minimum requirements by June 1, 1992.<sup>7</sup> The EU has taken significant steps to ensure a truly barrier-free, pan-European securities market.<sup>8</sup> However, it is

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fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1999). *See also* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951) ("The duty of disclosure stems from necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders."); Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947) (duty to disclose under Rule 10b-5 arises when "directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction.").

4. The European Union currently consists of the following countries: France, Germany, the UK, Belgium, the Netherlands, Luxembourg, Italy, Spain, Portugal, Greece, Denmark, and Ireland. Austria, Sweden, and Finland accepted membership in 1994 bringing the total number to 15 countries. The European Union (EU) has also entered into an agreement with the remaining nations of the European Free Trade Association ("EFTA") (Iceland, Liechtenstein, Norway, and Switzerland (unratified)). *See* Paul B. Stephan, *The New International Law- Legitimacy, Accountability, Authority, and Freedom in the New Global Order*, 70 COLO. L. REV. 1555, 1572-75 (1999).

5. Section 4(a) of the Securities and Exchange Act of 1934 establishes the Securities and Exchange Commission (SEC). *See* Securities Act of 1934, 15 U.S.C. § 78d (1994). The SEC is an independent regulatory body consisting of "five commissioners to be appointed by the President with the advice and consent of the Senate." *Id.* The Act directs that commissioners "shall be appointed alternatively as nearly as may be practicable" from different political parties. *Id.* The SEC has primary responsibility for implementing the Act and regulating United States securities markets, including rule making, market oversight and enforcement. *See id.*

6. *See* Council Directive 89/592 on Coordinating Regulations on Insider Dealing, O.J. L. 334/30 (1989) [hereinafter EU Directive]. The EU's Council Directive 89/592 was first proposed in 1987. However, the European Commission had been examining alternatives for dealing with insider trading since 1976. The earlier studies produced the "Commission's Recommendation Concerning a European Code of Conduct Relating to Transferable Securities," which was received without much enthusiasm. *See* Manning Gilbert Warren III, *The Regulation of Insider Trading in the European Community*, 48 WASH. & LEE L. REV. 1037, 1043-45 (1991).

7. *See* KAREN V. KOLE & ANTHONY D'AMATO, EUROPEAN UNION LAW ANTHOLOGY 126-48 (1982). Under the Treaty of Rome, directives are essentially orders to enact legislation given to the member states and issued by the Council and the Commission. *See id.* Except for regulations issued by the Council or the Commission, institutions do not generally have the authority to enact laws for the Community as a whole. Rather, the Council and Commission are vested with the power to demand that member states enact laws that further the goals of the Treaty of Rome. *See id.*

8. *See generally* Todd A. Sulger, Comment, *Harmonization of Securities Market Regula-*

clear to both investors in Europe and the United States, that the vagaries of insider trading have yet to be resolved.

For several reasons, the EU Directive has not effectively curbed insider trading, and therefore, not attracted the confidence or loyalty of United States investment in the European market.<sup>9</sup> First, after a lengthy history of sophisticated development in securities regulation, the United States is not eager to scale back on its securities requirements simply in the name of harmonization and convergence. United States investors are generally more inclined to invest in well developed and modernized financial markets rather than treading into emerging markets which are unfamiliar and still struggling to secure a basic, stable, economic infra-structure.<sup>10</sup> The European continent constitutes a relatively familiar and well-developed financial market. However, the nature and implications of the EU Directive sit uncomfortably with United States investors who are used to securing their prospects on implied causes of action and precedent. Second, European countries are not enamored with the idea of being forced to abide by what undoubtedly constitutes a United States dominated securities regulatory scheme. Finally, at the root of the discrepancies and discomfort currently posing a hindrance to what could be a confident and efficient financial exchange between the United States and EU, are the differences in legal culture.<sup>11</sup> One of the first steps in approaching incongruous securities market regulations is recognizing that cultural and legal distinctions are not easily eradicated. Therefore, these differences should be considered, minimized, and incorporated into the regulation of transnational securities markets.

A certain level of harmonization is necessary to foster a common area of

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*tions in the European Union: Is the Price Tag Too High?*, 29 CAL. W. INT'L L.J. 221 (1998) (describing a number of directives that were implemented in order to orchestrate the harmonization of the EU member states' securities regulation requirements including the Admissions Directive, the Interim Reports Directive, and the Listing Particulars Directive).

9. The measures necessary to achieve honesty and efficiency are different in each member state due to varying market structures existing in the EU. While the directives achieve a minimum level of regulation, member states are still free to set their own bar, which may or may not be higher. See generally Andreas J. Roquette, *New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany*, 14 U. PA. J. INT'L BUS. L. 565 (1994); see Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69, 83 (1994) (discussing how emerging financial markets are often faced with the lack of accounting and compliance infrastructures necessary for successful operation of a complex securities market).

10. See John Reed, *Central European Economic Review: Banks in the Balance*, WALL ST. J. EUR., Sept. 28, 1998, at 12, available in 1998 WL-WSJE 12732629. "In Poland and Hungary, the two countries to open earliest and widest to Western capital, foreigners have sparked a revolution of sorts in banking, investing capital to upgrade technology and strengthen banks' asset bases." *Id.*

11. See generally Gerhard Wegen, *Congratulations From Your Continental Cousins, 10b-5: Securities Fraud Regulation From the European Perspective*, 61 FORDHAM L. REV. S57 (1993); Keith D. Nunes et al., *French & SEC Regulations: The Search for Transparency and Openness in Decisionmaking*, 26 VAND. J. TRANSNAT'L L. 217 (1993).

understanding between countries with otherwise very different legal, political, and social foundations.<sup>12</sup> However, such commonality must be tempered with the added effort of mutual recognition and respect for each other's variances and cultural identities. This is important because it is evident that European countries are wary of relinquishing their sovereign authority and domestic identity to a supra national EU regulatory body. Furthermore, the economic gains may not be enough to make up for the loss in cultural sovereignty.<sup>13</sup> Harmonization may not be the simplest manner to implement a successful securities market regime in co-existence between the United States and European securities markets. However, it may constitute an approach which both the United States and Europe can live with.

Part I outlines the United States' perspective on insider trading and its development via statutes, judicial interpretations, and legislative initiatives, and the EU's response to insider trading, focusing on EU Directive 89/592.<sup>14</sup> Part II examines potential limitations and difficulties of harmonizing insider trading rules by considering the United States' concern with avoiding a system of regulations which meet only bare minimum requirements, the difficulties in understanding and agreeing upon terms defining insider trading, and the extent of their impact. This section also addresses the more abstract concept and importance of legal cultural distinctions between the United States and the EU. Finally, by projecting the practice of subsidiarity to the arena of insider trading regulations, Part III offers an approach for reconciling varying insider trading regulations with the goal of increasing United States participation and confidence in the European securities market.

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12. See generally James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119 (1996). Scholars have acknowledged that these solutions, which fall under the general heading of corporate governance, do not arise solely from the evolution of some fundamental economic order or logic, but are shaped by social, political, and more generally, cultural forces, often unique to a particular country. The foremost United States advocate of this position is Professor Roe, who explains the development of United States corporate governance from a political perspective. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). According to Professor Roe, economic development led to the rise of the large public corporation with dispersed shareholders and professional managers. How a particular country responds to this phenomenon to produce a corporate governance "equilibrium" or solution characteristic of that country depends upon numerous ideological, political and historical factors ("cultural" factors) in addition to economic forces. See *id.* Non-United States academics and writers have also examined their own, and other, corporate governance systems. See, e.g., EUROPEAN BUSINESS LAW: LEGAL AND ECONOMIC ANALYSES ON INTEGRATION AND HARMONIZATION (Richard M. Buxbaum et al. eds., 1991) (reviewing worldwide harmonization and capital market developments).

13. See Sulger, *supra* note 8, at 238-39.

14. See EU Directive, *supra* note 6.

## I. OVERVIEW OF INSIDER TRADING

### A. *United States Perspective on Insider Trading*

The prosecution of insider trading violations has been more vigorous in the United States than in any other country.<sup>15</sup> This rigor stems from the traditional belief that insider trading violates basic notions of fairness and undermines public confidence in the integrity of the stock market. Nevertheless, Congress has never precisely defined insider trading. Generally considered a term of art, insider trading refers to any unlawful trading of publicly traded securities by persons possessing material, nonpublic information.<sup>16</sup> As a result, a combination of innovative legislative tools and creative judicial interpretations have formed the basis of United States insider trading jurisprudence.

#### 1. *Statutory Framework*

Originally, regulation of insider trading was founded on a system of disclosure provided for in the Securities and Exchange Act of 1934 (SEA of 1934).<sup>17</sup> Congress hoped to avoid the problem of insider trading by requiring multiple disclosures through continuous reporting obligations, and by providing for, in section 16 of the SEA of 1934, the reporting of securities transactions, and the preclusion of short-swing trading by certain insiders.<sup>18</sup>

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15. See HAMILTON, *supra* note 3, at 817-18. Supreme Court decisions reflect an expansive and broad reading of Rule 10b-5. In addition, several procedural advantages exist to encourage the use of Rule 10b-5, "including nationwide service of process under 15 U.S.C. § 27 of the Securities Exchange Act of 1934, liberal venue provisions, and generous discovery rules." *Id.* Further, "the doctrine of pendent jurisdiction permits a federal court to hear both the rule 10b-5 claim and the state claim in a single proceeding." *Id.* "The United States and the Commission [SEC] have been world leaders in outlawing and prosecuting insider trading." James R. Doty, *The Role of the Securities and Exchange Commission in an Internationalized Marketplace*, 60 FORDHAM L. REV. 577, 583 (1992).

16. See generally Bryan C. Smith, Comment, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371 (1999).

17. See 15 U.S.C. § 78a (1994).

18. See HAMILTON, *supra* note 3, at 899-900. Section 16(b) of the Securities and Exchange Act of 1934 provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . .

15 U.S.C. § 78(p) (1988). See generally Steve Thel, *The Genius of Section 16: Regulating the*

Indeed, section 16(b) imposes strict liability on insiders for short-swing profits regardless of the nature of the information used in making the trade. However, its potential as an effective weapon against insider trading is flawed because only a corporation or a shareholder that sues derivatively may bring a section 16(b) action. This limitation has left the SEC powerless to prosecute section 16(b) violations.

As concern over insider trading increased, section 10(b) of the SEA of 1934 and Rule 10b-5 promulgated thereunder, became the most common used sources of authority to regulate insider trading offenses. Rule 10b-5 is a general anti-fraud prohibition that makes the use of any "device, scheme, or artifice to defraud,"<sup>19</sup> any misleading statement of material fact, or the operation of any fraud or deceit on any person in connection with the purchase or sale of any security unlawful.<sup>20</sup> The broad and general language of Rule 10b-5 provides both the rule's strength and weakness.<sup>21</sup> While its failure to define insider trading has led to confusion among market professionals, this ambiguity has also provided the flexibility federal courts need to respond to alleged violations.<sup>22</sup> Accordingly, judicial interpretation of the anti-fraud rules has alternately expanded or contracted, as their reach is modified to suit different circumstances.<sup>23</sup>

## 2. Judicial Interpretation

Rule 10b-5 was found to create an implied right in a private cause of action for the first time in the 1946 case of *Kardon v. National Gypsum Co.*<sup>24</sup> The opportunity for private claims strengthened the detection and punishment of insider trading violations.<sup>25</sup> Rule 10b-5's reach was truly tested, however, in *In re Cady, Roberts & Co.*,<sup>26</sup> where it was applied to corporate outsiders trading on nonpublic information.<sup>27</sup> Adopting the SEC's preference

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*Management of Publicly Held Companies*, 42 HASTINGS L.J. 391 (1991) (detailing the enactment of Section 16 of the SEA and the purpose of Section 16(b)).

19. See 17 C.F.R. § 240.10b-5 (1997).

20. See *id.* See generally Lawrence J. Zweifach, *Basic Principles of the Law of Insider Trading*, 1070 PLI/CORP. 467 (1998); Paul H. Dawes, *The Mens Requirement for Criminal Liability Under Section 10b and Rule 10b-5*, 1070 PLI/CORP. 515 (1998).

21. See generally Charles Vaughn Baltic, III, *The Next Step in Insider Trading Regulation: International Cooperative Efforts in the Global Securities Market*, 23 LAW & POL'Y INT'L BUS. 167 (1992) (noting that Congress has yet to clearly define the crime of insider trading).

22. See *id.* at 175.

23. See generally Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993) (discussing how insider trading should be regulated from an economic perspective).

24. 69 F. Supp. 512, 514 (E.D. Pa. 1946).

25. See *id.*

26. 1961 WL 3743 (S.E.C.).

27. See *id.* at \*1. The S.E.C. reasoned that the unfair advantage gained by access to non-

for a sweeping prohibition, courts applied the catch-all “disclose or abstain rule.” First announced in *SEC. v. Texas Gulf Sulphur Co.*,<sup>28</sup> this rule requires anyone possessing material, nonpublic information about a corporation to either disclose the information publicly, or to refrain from trading in its securities.<sup>29</sup> Even temporary insiders such as lawyers, accountants, and investment bankers have been held to this duty.<sup>30</sup> Most important, courts have also extended insider trading liability to tippees, individuals who receive nonpublic information from an insider.<sup>31</sup>

However, several constraints have been placed on the scope of insider trading liability. In *Chiarella v. United States*,<sup>32</sup> the Supreme Court held that the duty to disclose arises only when a fiduciary relationship exists between the trader and the corporation.<sup>33</sup> In *Chiarella*, an employee of a financial printing firm traded on information left at the printer regarding tender offers.<sup>34</sup> The employee was found not to have a sufficiently close relationship of trust and confidence with the tendered companies and its shareholders to trigger the duty to disclose or abstain.<sup>35</sup> As a result, the Court found not only that the mere possession of nonpublic information is insufficient to create a duty to disclose or abstain, but also, that even trading on nonpublic information is not in itself enough to incur liability under Rule 10b-5.<sup>36</sup>

In *Dirks v. SEC.*,<sup>37</sup> the Supreme Court defined the relationship between a breach of a fiduciary duty and tipper-tippee liability. In *Dirks*, for the tipper to be found to have breached his fiduciary duty, the Court required the tipper to communicate inside information to a tippee for “pecuniary gain.”<sup>38</sup> The Court reasoned that “[a]bsent some personal gain, there has been no breach of duty to the stockholders.”<sup>39</sup> Because the tippee’s duty is derivative of the tipper’s duty, there can be no liability for the tippee absent a breach of duty by the insider.<sup>40</sup> To escape these limitations, some courts have relied upon a misappropriation theory,<sup>41</sup> which was first enunciated by Chief Justice Bur-

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public information justified subjecting the defendant to liability. *See id.* at \*7.

28. 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

29. *See id.*

30. *See Dirks v. SEC.*, 463 U.S. 646, 655 (1983).

31. *See id.* at 647.

32. 445 U.S. 222 (1980).

33. *See id.* at 230.

34. *See id.* at 224.

35. *See id.* at 232-33.

36. *See id.* at 235-36.

37. 463 U.S. 646 (1983).

38. *Id.* at 659. In *Dirks*, a stock analyst disclosed to his clients the nonpublic information that the assets of Equity Funding of America were vastly overstated. *See id.* at 648-50. The analyst received the information from a corporate insider who was motivated not by personal gain but rather by the desire to reveal corporate fraud. *See id.*

39. *Id.* at 662.

40. *See id.*

41. *See United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff’d*, 722 F.2d 729 (2d Cir. 1983), *cert. denied*, 466 U.S. 863 (1983).

ger in his dissent in *Chiarella*.<sup>42</sup> Under this theory of liability, a duty to disclose or abstain is imposed on any person who has misappropriated or stolen nonpublic information.<sup>43</sup> However, the Supreme Court still requires a breach of a fiduciary duty.<sup>44</sup>

Finally, in *United States v. O'Hagan*,<sup>45</sup> the Supreme Court held that by giving the SEC authority to regulate nondeceptive activities as a reasonably designed means of preventing manipulative acts under section 14(e) of the SEA of 1934, the "Commission may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'"<sup>46</sup> However, *O'Hagan* leaves blurred some of the contours of the tort of trading on undisclosed tender offer information. In particular, it is unclear whether mere "possession" of insider information is sufficient to constitute a prohibitive fraudulent act under section 14(e) of the SEA of 1934 because the Court described the wrong as trading "on the basis" of inside information.<sup>47</sup> Insider trading can be sanctioned by the SEC like violations of Rules 10b-5 or 14e-3, in an injunctive action or agency disciplinary proceeding.<sup>48</sup> Furthermore, in 1988, Congress increased sanctions for insider trading by creating a private right of action on behalf of contemporaneous traders.<sup>49</sup> Additionally, Congress inserted a new bounty provision for informers on insider trading,<sup>50</sup> increased criminal fines,<sup>51</sup> and gave the SEC greater authority to investigate international securities law violations.<sup>52</sup> Though the Court in *O'Hagan* purported to decide when a person who is neither a corporate insider, nor a temporary insider is forbidden from trading based on material,<sup>53</sup> nonpublic information, a rather confusing opinion left many questions unresolved.<sup>54</sup> Whatever resolu-

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42. 445 U.S. at 240-45 (Burger, J., dissenting).

43. See *id.* at 240.

44. See *Carpenter v. United States*, 484 U.S. 19, 24 (1987) (the Court deadlocked on the issue of whether a financial newspaper reporter misappropriated information that was to be discussed in future newspaper columns, and whether this created Rule 10b-5 liability even though the reporter did not owe a fiduciary duty to the companies or their shareholders).

45. 521 U.S. 642 (1997).

46. *Id.* (quoting 15 U.S.C. § 78n(e) (1994)).

47. See *id.* at 676-77.

48. See 15 U.S.C. §§ 78u(d)(1), (d)(3), 78u-2, 78u-3 (1994).

49. See *id.* § 78t-1(a).

50. See *id.* § 78u-1(e).

51. See *id.* § 78ff(a).

52. See *id.* § 78b(1).

53. In *TSC Indus., Inc. v. Northway, Inc.*, the Supreme Court reversed the Seventh Circuit's application of materiality and held that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." 426 U.S. 438, 439 (1976). Materiality is a controlling concept when allegations of fraud are alleged and is a mixed question of law and fact. See *id.* at 449-50. Generally the concept of materiality has been defined as information "which might have been considered important by a reasonable" investor and then that the test requires "a significant propensity to affect" investors. *Id.* at 449.

54. See Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United*



tions or proposals the SEC or Congress employ to clarify the definition of insider trading, they will both have to consider that securities laws were designed to protect investors and the well being of an investor who trades with a person in possession of material, nonpublic information.<sup>55</sup>

### 3. Legislative Initiatives

In spite of the conflicting theories of liability employed by the judiciary, it remains well settled that insider trading offenses under Rule 10b-5 require proof that the trade involved a violation of a fiduciary duty.<sup>56</sup> Moreover, a tippee can only be held liable when the insider has breached a duty to the company or its shareholders, and the tippee knew, or should have known such a breach occurred.<sup>57</sup> In 1980, in an attempt to counteract the impact of this requirement in the arena of corporate takeovers, the SEC promulgated Rule 14e-3.<sup>58</sup> This rule expressly prohibits anyone possessing information relating to a tender offer from trading if she 1) knows or has reason to know that the information is nonpublic; 2) and knows or has reason to know that it has been acquired directly or indirectly from persons associated with either the acquiring or target company.<sup>59</sup> Therefore, unlike an action under Rule

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*States v. O'Hagan*, 84 VA. L. REV. 153-54 (1998). Concerned with the logic and predictability of the case law of *O'Hagan* and other civil and criminal penalties, an *amicus curie* brief was filed by Law Professors in support of Respondent. See Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent, *United States of America v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), available in 1997 WL 143793. In their *amicus* brief, the authors urge the Supreme Court to affirm the Eighth Circuit's holding arguing that the misappropriation theory does not comport with the text of, or purpose of, the SEA of 1934. See *id.*

55. See Painter et al., *supra* note 54, at 228 n.5.

56. See HAMILTON, *supra* note 3, at 833.

57. See *id.*

58. See 17 C.F.R. § 240.14e-3 (1994).

59. Rule 14e-3 provides in pertinent part:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer,
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3 (1994). See also *United States v. Chestman*, 947 F.2d 551, 560 (2d Cir.

10b-5, a Rule 14e-3 action does not require a breach of a fiduciary duty.<sup>60</sup>

In the context of takeovers, the SEC has set a trap to ensnare would-be insider traders. Although Rule 14e-3's application is limited to tender offers, its adoption and use by the SEC, underscores the agency's preference for an interpretation of insider trading that focuses on the mere possession of material, nonpublic information rather than on a breach of a fiduciary duty.<sup>61</sup> Moreover, because a large amount of insider trading abuses relate to takeovers, Rule 14e-3 is an effective regulatory addition to the legislative tools used to thwart this practice.<sup>62</sup>

#### 4. Enforcement

Insiders who willfully violate securities laws are subject to both criminal and civil penalties. Criminal penalties include prison sentences of up to ten years, and fines of up to \$1 million for individuals, and up to \$2.5 million for corporations.<sup>63</sup> Civil liability includes fines, disgorgement of profits, and injunctions against further securities trading.<sup>64</sup> However, notwithstanding these stiff penalties and the increased scrutiny of investment houses, the 1980s witnessed several notable insider trading scandals. In 1986, the SEC

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1991) (the court held that "the language and legislative history of section 14e [of the 1934 Act], as well as congressional inactivity toward it since the SEC promulgated Rule 14e-3(a), all support the view that Congress empowered the SEC to prescribe a rule that extends beyond the common law.").

60. Exploiting this difference between the rules, the Second Circuit, in its en banc decision in *Chestman*, applied Rule 14e-3 to extend liability to a remote tippee who would not otherwise have been liable under Rule 10b-5. See *Chestman*, 947 F.2d 551-64. In *Chestman*, a senior company official at Waldbaum told his sister that a tender offer was about to be made for his company. See *id.* at 555. His sister then passed the information to her daughter who then passed it on to her husband (Loeb) who in turn disclosed news of the impending bid to his stockbroker (Chestman). See *id.* Chestman then purchased shares of Waldbaum stock for his personal and customer accounts. See *id.* Chestman was not found liable under Rule 10b-5 as there was insufficient evidence of a breach of fiduciary duty between the tipper, Loeb and Waldbaum. See *id.* at 571. However, Chestman was convicted under Rule 14e-3, as his trades were based on possession of information related to a tender offer that he knew or had reason to know was both nonpublic and supplied (directly or indirectly) by an insider. See *id.*

61. See Smith, *supra* note 16, at 371 (though the SEC is concerned about demonstrating the link between possession and use of insider information, the Ninth Circuit currently endorses a causation standard which requires proof of actual use of information to constitute a Rule 10b-5 violation).

62. Congress has adopted several measures to combat the misuse of privileged market information. The Insider Trading Sanctions Act gives the SEC the authority to seek civil penalties up to three times the profits made from the unlawful purchase or sale of securities. See 15 U.S.C. § 78u-1 (1998). In 1988, Congress also passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA). See *id.* ITSFEA imposes civil penalties on "controlling persons" who know or should have known that individuals under their supervision are likely to engage in insider trading. See § 78u-3 (1998).

63. See 15 U.S.C. § 78u-1 (1988).

64. See generally Matthew A. Aufman, *Civil Liability Under Exchange Act Rule 10b-5 for Misappropriators of Nonpublic Information: An Argument for Consistency*, 40 B.C. L. REV. 829 (1999).

successfully prosecuted Dennis Levine, a former director of Drexel Burnham Lambert, for trading on insider information at an estimated profit of over \$12 million.<sup>65</sup> That same year, arbitrageur Ivan Boesky paid a fine for purchasing securities prior to takeover announcements that was more than eight times Levine's estimated profit.<sup>66</sup> Finally, the scandal involving Michael Milken, who made more than \$550 million from the securities business in 1987 alone, dwarfed the stir created by both Boesky and Levine.<sup>67</sup>

The outrage these scandals ignited in the United States illustrate that public frustration concerning insider trading can be one of the most important deterrents against it.<sup>68</sup> Add to this the SEC's formidable resources for the enforcement of securities laws, and it is understandable why the United States is one of the worlds most hostile environments for insider trading.<sup>69</sup> However, in spite of the comprehensive statutory scheme in the United States, it remains dependent on case law for full legal guidance. This results in lingering confusion as to the precise contours of "insider trading."

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65. See generally Lawrence A. Cunningham, *The Heyman Center's Roundtable on Insider Trading: Law, Policy, and Theory After O'Hagan*, 20 CARDOZO L. REV. 1 (1998).

66. See, e.g., Nancy Reichman, *Insider Trading*, 18 CRIME & JUST. 55 (1993). Over the past 15 years, insider trading scandals have received substantial media attention. In the 1980s, there were countless front-page stories about insider trading prosecutions against high-powered deal makers such as Ivan F. Boesky, Michael R. Milken, and Dennis B. Levine. In the 1990s, the SEC and federal prosecutors continued to pursue insider trading investigations and prosecutions aggressively. However, unlike the prosecutions of the 1980s, the defendants in recent insider trading cases tend to be corporate executives and directors, as well as their neighbors, friends, relatives, lawyers, doctors, and consultants. "Today, even as regulators keep a sharp eye on Wall Street, most of the action has been on Main Street." *Insider Trading*, BUS. WK., Dec. 12, 1994, at 70. Thus, "insider trading has gone Middle American." *Id.*

67. See *Mike Milken's Days in Court are Over*, BUS. WK., Apr. 1, 1991, at 68. "The SEC has never wholly abandoned the parity of information theory, but rather has based its actions on the egregious facts of numerous cases, public outrage concerning these cases, and whatever theories the Supreme Court appeared to permit." Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 106 (1998). "Regardless, with respect to the insider trading scandals of the 1980s involving Dennis Levine, Ivan Boesky, Michael Milken, and numerous other traders, theory hardly mattered in prosecuting and settling cases and persuading Congress to increase the penalties for trading on insider information." *Id.* During these scandals the ex-chairman of the SEC, John Shad, spoke about the ban on insider trading:

Countries with broad public ownership of securities generally enjoy the greatest economic and political stability. Insider trading benefits the few at the expense of the many. It impugns the integrity of the securities markets. It is hardly fair to pit the investing public against those who have access to inside information. It is and should be illegal.

*Id.*

68. See Robert Maxwell, *Lesson From Maxwell*, ECONOMIST, Dec. 14, 1991, at 16.

69. See *Balancing Act: Insider Dealing*, ECONOMIST, May 22, 1993, at 84 (stating that the SEC leads the world in insider trading prosecutions with an average of 30-40 cases a year).

### B. The EU's Response to Insider Trading

Unlike the United States, where insider trading is regulated under a general anti-fraud provision, the EU has chosen to enact specific prohibitions to curtail this practice.<sup>70</sup> In 1986, only three of the EU's twelve member states forbade insider dealing.<sup>71</sup> Indeed, until recently, insider trading was considered a valid part of business practice in Europe.<sup>72</sup> As the EU begins to remove obstacles to mergers and acquisitions, and as European companies rely more heavily on the market for capital, the potential harm to be wrought by improper use of inside information continues to rise.<sup>73</sup> Consequently, fear of disruption to their smooth functioning stock exchanges has prompted many Europeans to change their perception of insider trading.<sup>74</sup> The resulting momentum for change, propelled in part by a slew of European insider trading scandals in the 1980s,<sup>75</sup> led to the EU's adoption in 1989 of Council Directive 89/592: Coordinating Regulations on Insider Dealing.<sup>76</sup>

#### 1. Evolution of the European Union's Insider Trading Directive

The Commission of the European Union (EU Commission), the legislative body responsible for the initiation of directives within the EU, originally hoped to regulate insider trading by adopting the European Code of Conduct.<sup>77</sup> Although the European Code of Conduct received a lukewarm reception from member states, it provided a blueprint for the EU Commission's working party, which first met in 1976, to discuss the implementation of legally binding insider trading rules through an EU directive.<sup>78</sup> Over the opposition of several member states, especially Germany, the EU Commission created a draft directive in 1987.<sup>79</sup> It subsequently passed a slightly modified

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70. See Sulger, *supra* note 8, at 221-22. One of the EU's main objectives has been to increase free trade among the EU countries including securities transactions. Over the last decade the EU has created numerous increasingly detailed directives in furtherance of complete harmonization of securities regulations. See *id.* Among the most significant are: 1) the Admissions Directive; 2) the Interim Reports Directive; and 3) the Listing Particulars Directive. See *id.* at 224.

71. Denmark, France, and the United Kingdom. See Leacock, *supra* note 1, at 54.

72. See generally Manning Gilbert Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181 (1994).

73. See generally Raffaello Fomasier, *The Directive on Insider Dealing*, 13 FORDHAM INT'L L.J. 149 (1990).

74. See *id.*

75. See, e.g., *Storming of the Bourse*, ECONOMIST, July 22, 1989, at 68.

76. See EU Directive, *supra* note 6.

77. See Leacock, *supra* note 1, at 71-72; Daniel James Standen, *Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change*, 36 HARV. INT'L L.J. 177, 184-85 (1995).

78. See Leacock, *supra* note 1, at 72.

79. See Standen, *supra* note 77, at 177.

version in 1988, which the EU Parliament approved on October 11, 1989.<sup>80</sup> Although the EU Commission ignored the European Parliament's pleas for stiffer sanctions, it yielded to British criticism by expanding the definition of insiders, lessening tippee liability, and increasing the powers of regulatory agencies in the member states.<sup>81</sup>

## 2. *The Content of the Insider Trading Directive*

Like United States securities laws, the objective of the EU Directive is public disclosure of market-sensitive information.<sup>82</sup> However, in contrast to its United States counterpart, the EU Directive does not focus on the fiduciary relationship between the insider and the company.<sup>83</sup> Rather, it focuses on possession of inside information and the relationship of the insider to all other market actors.<sup>84</sup>

### *a. Inside Information*

Article 1 of the EU Directive defines inside information as:

[I]nformation which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have significant effect on the price of the securities in question.<sup>85</sup>

The inclusion of the "has not been made public"<sup>86</sup> language encourages the disclosure of price-sensitive information.

### *b. Insiders*

Articles 2 and 4 of the EU Directive distinguish between primary and secondary insiders. In addition to standard company insiders, the primary insider category includes shareholders of the company and those who have access to inside information by virtue of their professional duties.<sup>87</sup> Secondary

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80. See Fornasier, *supra* note 73, at 152.

81. See KOLE & D'AMATO, *supra* note 7, at 126.

82. See Thomas Lee Hazen, *Defining Illegal Insider Trading—Lessons From the European Community Directive on Insider Trading*, 55 LAW & CONTEMP. PROBS. 231, 237-38 (1992).

83. See *id.*

84. See *id.*

85. EU Directive, *supra* note 6, art. 1(2).

86. *Id.*

87. Article 2(1) of the EU Directive states that each member state shall prohibit any person (inside trader) who:

by virtue of his membership of the administrative, management or supervisory bodies of the issuer, by virtue of his holding in the capital of the issuer, or because he has access to such information by virtue of the exercise of his employment, pro-

insiders are those who obtain inside information from primary insiders.<sup>88</sup> This differentiation corresponds roughly to the tipper/tippee insider trader distinction in the United States securities system.<sup>89</sup> However, an important difference from United States law, is that the primary insider (tipper) referred to in the EU Directive, does not necessarily have a fiduciary relationship with the company. Accordingly, the printer who was out of the reach of Rule 10b-5 in *Chiarella*, is treated as an insider under the EU Directive.<sup>90</sup>

### c. Prohibited Practices

Although the actions of primary and secondary insiders are regulated differently under the EU Directive, both types of insiders are barred from using nonpublic information to buy or sell securities, either for their own accounts or for the accounts of others.<sup>91</sup> However, to be liable, the insider must act "with full knowledge of the facts,"<sup>92</sup> mere negligence is not enough. Simply stated, insiders must have known what they were doing. Although a precise definition of scienter has not been articulated in the United States, it is well settled that the defendant must at least have had an awareness of the relevant facts.<sup>93</sup> The EU Directive also prohibits primary insiders from disclosing inside information to third parties, and from recommending or procuring securities for a third party based on inside information.<sup>94</sup> This prohibition creates a comprehensive restriction on tipping.

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fession or duties, possesses inside information from taking advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates.

EU Directive, *supra* note 6, art. 2(1).

88. *See id.* art. 4.

89. *See id.*

90. *See* 445 U.S. at 235-36.

91. *See supra* text accompanying note 87. Article 4 of the EU Directive imposes prohibitions on secondary insiders. *See* EU Directive, *supra* note 6, art. 4.

92. *See supra* text accompanying note 87.

93. Similarly, the courts in the United States have interpreted the language of Section 10(b) of the SEA of 1934 to contain a scienter requirement. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (stating that "[w]hen a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances the commonly understood terminology of intentional wrongdoing and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.").

94. Article 3 of the EU Directive prohibits primary insiders from:

- (a) disclosing that inside information to any third party unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;
- (b) recommending or procuring a third party, on the basis of that inside information to acquire or dispose of transferable securities admitted to trading on its securities markets as referred to in Article 1(2) in fine.

EU Directive, *supra* note 6, art. 3.

Primary insiders are barred from recommending stocks, even if they do not reveal the inside information on which their tips are based.<sup>95</sup> However, Article 3 of the EU Directive does contain an exception to this prohibition. Disclosures made in the ordinary course of the insider's employment or in the execution of his or her professional duties are not prohibited.<sup>96</sup> This exception permits the essential flow of information between market professionals such as banks, investment houses, law firms, and their corporate clients. It also embodies the United States' notion that to be guilty of insider trading, the insider must derive some sort of "pecuniary gain."<sup>97</sup>

Secondary insiders are regulated less strictly under the EU Directive. Pursuant to Article 4 of the EU Directive, they are prohibited from engaging in Article 2 transactions, namely trading in securities based on inside information.<sup>98</sup> Therefore, tippees are not prohibited from continuing the chain of information by engaging in tipping as long as they do not trade based on the information obtained. However, because primary insiders are barred from tipping, there is a gap in the EU Directive that cannot be fully explained. According to one theory, by allowing tippees to pass on information, the EU Directive allows for a free flow of information that will eventually purge inside information of its "inside" character.<sup>99</sup>

#### *d. Enforcement*

The EU Directive does not directly regulate insider trading, but instead relies on each member state to achieve this goal through the transformation of their national laws.<sup>100</sup> Specifically, the EU Directive mandates that member states punish Article 2 insiders for violations committed either 1) within the territorial boundaries of the member states; or 2) committed outside these boundaries and "carried out" in securities markets in one of the member states.<sup>101</sup> To ensure the enforcement of these measures, the EU Directive requires member states to designate authorities responsible for the proper application of its prohibitions.<sup>102</sup> The designated authorities must be provided

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95. *See id.* art. 3(b).

96. *See id.* art. 3(a).

97. *See supra* note 38 and accompanying text.

98. Article 4 of the EU Directive provides that:

Each Member State shall also impose the prohibition provided for in Article 2 on any person other than those referred to in that Article who with full knowledge of the facts possess insider information, the direct or indirect source of which could not be other than a person referred to in Article 2.

EU Directive, *supra* note 6, art. 4.

99. *See id.*

100. Article 14(1) of the EU Directive requires member states to take the "measures necessary to comply with" the directive by June 1, 1992. *Id.*

101. *See id.* art. 5.

102. *See id.* art. 8.

with "all supervisory and investigatory powers that are necessary for the exercise of their functions."<sup>103</sup> However, the EU Directive significantly fails to impose criminal penalties for violations<sup>104</sup> or to create a central EU agency to oversee uniform compliance by the member states.

### 3. Effectiveness of the Council Directive

The EU Directive's effectiveness is tested by its ability to reshape the permissive attitudes toward insider trading that have been ingrained through European business practice.<sup>105</sup> However, because most member states have only recently changed their laws, and are still struggling to create agencies to supervise the new regulations, the results of this test are inconclusive.<sup>106</sup> Nevertheless, it is foreseeable that in the absence of criminal sanctions or very serious civil penalties, the EU Directive may fail to make insider trading either as prosecuted, or as stigmatized an offense in the EU, as it is in the United States. Therefore, there is the danger that the EU Directive and its corresponding national laws will convey the false impression of a comprehensively regulated market-place,<sup>107</sup> thereby lulling investors into a false sense of security.<sup>108</sup>

In its defense, it can be argued that the EU Directive merely attempts to avoid the pitfalls of over-regulation through compromise and balance. Certainly, the separate regulations regarding tipping rules for primary and secondary insiders suggest the drafters' desire to avoid an overly broad prohibition. Although the curbing of insider trading is essential to the smooth functioning of European stock exchanges, the regulations must also allow enough room for professionals involved with the markets to do their jobs effectively, unimpeded by the constraints of legislative overreaching.<sup>109</sup>

Regardless of the disagreement over the lengths to which the EU Commission reached,<sup>110</sup> the fact remains that the EU Directive provides a relatively clear legal foundation for the prohibition of insider trading throughout the European community.<sup>111</sup> Furthermore, by furnishing clear definitions of inside information, insiders, and prohibited transactions, the EU Directive provides a model for the member states. Finally, by focusing on the posses-

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103. *Id.*

104. The EU Directive leaves the choice of type of penalty up to each member state. *See id.* art. 13.

105. *See Sulger, supra* note 8, at 224.

106. *See id.*

107. *See id.* at 228.

108. *See id.* at 229.

109. *See generally* *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (recognizing the importance of keeping certain information pertaining to merger negotiations confidential).

110. *See, e.g., Hazen, supra* note 82, at 237-38 (asserting that "[s]trict prohibitions against insiders who trade, coupled with an effective enforcement program, are adequate weapons against" insider trading).

111. *See Sulger, supra* note 8, at 228.



sion of inside information rather than on the breach of a fiduciary duty, the EU Directive is comprehensive enough to prevent more remote inside traders from slipping through the cracks in the system.<sup>112</sup>

Nonetheless, the EU Directive has room for improvement, particularly with regard to penalties and secondary insider liability.<sup>113</sup> Therefore, the challenge for the EU member states is to buttress the EU Directive's provisions to make insider trading violations something more than forgivable indiscretions.<sup>114</sup>

## II. LIMITATIONS ON THE HARMONIZATION BETWEEN UNITED STATES-EUROPEAN INSIDER TRADING LAWS FROM A UNITED STATES INVESTOR'S PERSPECTIVE

From a United States investor's perspective, the EU Directive is not an efficient regulatory tool because it fails to inspire a strong sense of confidence or motivation to channel money into the European market.<sup>115</sup> The explanation for this lies with three existing concerns. First, the United States is not inclined to ease up on securities regulations. However, with the rapid advancement of technology, globalization of securities markets is inevitable and the United States is now facing stiffer competition.<sup>116</sup> The United States can no longer rely on its place of dominance in this rapidly changing world of finance.<sup>117</sup> Second, there is a common sense recognition in the United States and in the EU, of the necessity in regulating insider trading more efficiently.<sup>118</sup> However, the dilemma of harmonizing the practical aspects of this recognition from the perspective of two different continents lies primarily in agreeing upon the labels which should attach to the complexities of insider trading and its consequences. Finally, closely linked to the dilemma of definition, is how, and particularly why, these definitional differences exist. In part, this may be explained by the distinctions in legal culture and tradition between the United States and EU countries.<sup>119</sup>

### A. Difficulties in Definitional Agreement and Extent of Applicability

Difficulties exist in defining standards in the area of insider trading and the extent of these definitions in the international arena of securities regula-

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112. For example, the printer in *Chiarella* and the broker in *Chestman* would both be liable under the EU Directive as primary insiders. See *Chiarella v. United States*, 445 U.S. 222, 224 (1980); *United States v. Chestman*, 947 F.2d 551, 552 (2d. Cir. 1991).

113. See Sulger, *supra* note 8, at 230-32.

114. See *id.*

115. See Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241, 288-95 (1997).

116. See *id.* at 247-54.

117. See *id.*

118. See *id.* at 257-72.

119. See Sulger, *supra* note 8, at 238-40.

tion. Although United States securities markets are regulated more heavily than most others, even slight variations from the United States model can have a significant effect on the applicability of insider trading laws.<sup>120</sup> In addition, national philosophies as well as a country's allocation of resources to combat prohibitive conduct in securities transactions, determine the extent to which violations of securities laws, specifically insider trading activities, are sanctioned in individual nations.<sup>121</sup> The following is a review of the central aspects and differences of insider trading regulations in the United States and Europe.

### 1. Criminal or Civil Liability

Generally, statutes which include civil liability require lesser standards of proof than those that impose criminal liability.<sup>122</sup> Therefore, countries that enact civil sanctions against insider trading are more successful in effectively punishing violators than those that impose only criminal sanctions.<sup>123</sup> United States regulations are unique in that they developed predominantly from a general criminal anti-fraud statute.<sup>124</sup> Today, however, violators in the United States are subject to both criminal and civil penalties.<sup>125</sup> Likewise, the United Kingdom, France, and Denmark began their regulation of securities transactions by criminalizing insider trading.<sup>126</sup> However, only the United Kingdom has followed the United States in imposing civil liability as well.<sup>127</sup> The EU Directive fails to establish any uniform sanctions for the member states.<sup>128</sup> Pursuant to the aforementioned French and Danish prohibitions, the agency charged with prosecuting insider trading offenses in these countries is faced with the difficult burden of establishing each element of a criminal offense before sanctions are available.<sup>129</sup> This requirement severely hampers

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120. *See id.*

121. *See id.* at 238-39.

122. *See Dawes, supra* note 20.

123. *See id.*

124. *See id.*

125. *See generally* Paul Vizcarrondo, Jr. & Andrew C. Houston, *Liabilities Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18 and 20 of the Securities Exchange Act of 1934*, 1073 PLI/CORP. 111 (1998).

126. *See generally* 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 (1998); Michael D. Mann et al., *Developments in International Securities Law Enforcement and Regulation*, 845 PLI/CORP. 9 (1994).

127. *See* Gerald A. Polcari, *A Comparative Analysis of Insider Trading Laws*, 13 SUFFOLK TRANSNAT'L L.J. 167, 176 (1989) (comparing insider trading laws from the United States, United Kingdom, Germany and Australia).

128. *See generally* Sandra K. Miller, *Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the United States: A Comparative Analysis of United States, German and U.K. Veilpiercing Approaches*, 36 AM. BUS. L.J. 73 (1998); Mary Jane Dundas et al., *The Transposal Processes of the EC Directives and the United States Uniform Codes: A Comparative Analysis*, 21 B.C. INT'L & COMP. L. REV. 43 (1998).

129. *See* Doty, *supra* note 15, at S79-84.

the effectiveness of these regulations.<sup>130</sup> Uniform establishment of civil liability for insider trading activity would assist the international enforcement of insider trading laws in these nations.<sup>131</sup>

## 2. "Insiders"

Lack of a specific definition for "insiders" is another element that has a substantial impact on the effectiveness of insider trading laws.<sup>132</sup> A provision without a general framework for defining "insiders" may be too broad to provide effective regulation because enforcers may be reluctant to subject anyone to liability.<sup>133</sup> Conversely, an overly strict definition of "insiders" may impede enforcement efforts by making it difficult to fit potential violators into the narrow classification required under the law.<sup>134</sup>

The definition of "insiders" is not precisely defined in the United States.<sup>135</sup> However, rather than impeding enforcement of insider trading, the lack of a strict definition has instead permitted a broad application of liability for insider trading.<sup>136</sup> Currently, under United States law, an insider must, at a minimum, have a fiduciary duty to either disclose material, nonpublic information, or refrain from trading.<sup>137</sup> This fiduciary duty has also been extended to "temporary insiders" and tippees.<sup>138</sup> The EU Directive also adopts a moderate definition, including both fiduciaries and tippees,<sup>139</sup> to avoid either a very limited or an over-broad construction.<sup>140</sup> By requiring an issuer to disclose material information, the intent of the EU Directive is to reduce the frequency of insider trading by regulating factors contributing to the circumstances affording personal gain on nonpublic information.<sup>141</sup>

Even though the EU Directive creates a base line standard to be followed by member states, the EU Directive's definition of "insiders" does little to instill a sense of confident investment practices by United States inves-

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130. *See id.*

131. *See Geiger, supra* note 115, at 316-17.

132. *See Georgakopoulos, supra* note 23, at 49.

133. *See id.*

134. *See Hazen, supra* note 82. By providing an express definition of insider trading, the U.K. has created a more restrictive application of the law. *See id.*

135. *See HAMILTON, supra* note 3, at 894-95.

136. *See id.* The absence of a definition for insider trading has led to expansive interpretation by the courts of impermissible insider trading conduct that has enabled the SEC to successfully prosecute an increasing number of violator. *See id.*

137. *See id.* at 753.

138. *See, e.g., State Teachers Retirement Bd. v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984) (holding that tippee liability requires that the tippee have "knowledge of each element, including the personal benefit, of the tipper's breach."). There is also a possibility that this common-law definition of insiders extends to those who misappropriate this information. *See id.*

139. *See Hazen, supra* note 82.

140. *See Geiger, supra* note 115, at 272.

141. *See Hazen, supra* note 82, at 237-38.

tors in the EU market.<sup>142</sup> Although the EU Directive is an initial step in establishing a unified set of securities regulations, it has not gone far enough.<sup>143</sup> Specifically, the EU Directive creates no more than a minimum standard for securities transactions regulatory compliance.<sup>144</sup> Thus, after a EU country meets the minimal standard set out by the EU Directive, it may wish to expand its insider trading rules to include more detail, scope and impact.<sup>145</sup> Although the evolution of the EU has been towards unification in a legal, political and social sense,<sup>146</sup> the evolution of securities regulations in the EU, including insider trading, continue to exist on a multi-tiered plane.<sup>147</sup> For a United States investors the problem consists in distinguishing what should be considered unified and all inclusive, and what must be viewed as discrete units within a larger union.<sup>148</sup> Consequently, United States investors will face varying levels of deterrence in each member state.<sup>149</sup> In sum, the absence of uniform definitions among the EU countries significantly undermines the EU Directive's original goal of standardizing insider trading prohibitions.

On its face, the EU Directive appears extensive in scope.<sup>150</sup> Though, some argue that the EU Directive's lines have been relatively well established, the exact location of those lines is far from clear.<sup>151</sup> For example, unlike the United States' definition for "insiders," it is clear that the EU Directive fails to state exactly who may, or may not be considered an "insider." Arguably, a vague definition of "insiders" could reach more broadly to those who would otherwise merely be border-line cases. Ultimately however, this factor remains an unknown to United States investors who will likely feel less comfortable investing in a market based on vague definitions.

Finally, the EU Directive regulates the activities of a cadre of personnel, encompassing more than just a few persons closely associated with a company, and arguably even reaches "tippees."<sup>152</sup> However, the EU Directive does not expressly prohibit tippees from simply passing insider information on to subsequent tippees.<sup>153</sup> Similar to the United States, true insiders are

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142. See Joseph F. Jacob, Note, *The Impact of the Euro on the United States Equity Markets*, 13 ST. JOHN'S J. LEGAL COMMENT 399, 400-05 (1998); Ruggiero, *supra* note 1, at 192; Leacock, *supra* note 1, at 51.

143. See Sulger, *supra* note 8, at 240.

144. See *id.*

145. See *id.*

146. See KOLE & D'AMATO, *supra* note 7, at 103, 285. See generally Hugo Paemen, *The European Union in International Affairs: Recent Developments*, 22 FORDHAM INT'L L.J. S136 (1999) (describing how one of the main objectives of the EU is the free movement of goods, persons, services, and capital between its member states' borders).

147. See Sulger, *supra* note 8, at 238-39.

148. See generally Dundas, *supra* note 128.

149. See *id.*

150. See Sulger, *supra* note 8, at 224.

151. See Hazen, *supra* note 82, at 237.

152. See, e.g., *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) (defining "tippees" as "persons given information by insiders in breach of trust.").

153. See *supra* text accompanying note 94.

prohibited from trading on inside information.<sup>154</sup> However, a major difference exists concerning the reach of the insider trading definition between the EU countries and the United States. One who overhears information, knowing it to be material, and nonpublic would be considered a secondary insider and thus such a person would be a remote tippee. Unlike regulations in the United States, the EU Directive focuses on the source of information rather than on whether that source breached an obligation by passing on information.<sup>155</sup>

### 3. "Inside Information"

Like the definition of "insiders," statutory definitions of inside information can have a profound effect on the applicability and effectiveness of insider trading regulations. United States laws fail to include a specific definition of inside information. Specifically, the definition of inside information was left out of Rule 10b-5.<sup>156</sup> However, later provisions establish that insider information consists of "material, nonpublic information."<sup>157</sup> This construction of inside information provides an adequate framework for imposing liability, but remains broad enough to allow wide application. On the other hand, the EU Directive includes a corresponding definition of inside information, defining it as nonpublic information that would have significant impact on the price of the security if it were made public.<sup>158</sup>

### 4. Class of Securities Regulated

By limiting the scope of insider trading statutes to securities that are traded on a formal organized exchange, the efficiency of such statutes are seriously undermined and less efficient.<sup>159</sup> United States regulations are applicable to securities traded both on or off an exchange,<sup>160</sup> and the EU Directive regulations apply to the trading of both listed securities and off-market transactions.<sup>161</sup> With off-market trading activity increasing, application of insider trading regulations to informal exchanges also becomes more impor-

154. See Hazen, *supra* note 82, at 237-38.

155. See *id.* at 238.

156. See 17 C.F.R. § 240.10b-5 (1997).

157. See *TSC Industries Inc.*, 426 U.S. at 438 (defining materially as information regarding a security that a reasonable investor would consider important).

158. See Steven R. Salbu, *Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach*, 66 TUL. L. REV. 837, 844-47 (1992); Fornasier, *supra* note 73.

159. The United Kingdom's prohibition of off-market trading is the primary reason it is viewed as having the most comprehensive insider trading regulations of the EU member states. France and Denmark, for example, each place this restriction on the application of their laws. See Ruggiero, *supra* note 1.

160. See 15 U.S.C. § 78b (1994).

161. See Robert W. Helm & David A. Vaughan, *Creating, Managing and Distributing Offshore Investment Products: A Legal Perspective*, 1035 PLI/CORP. 583, 589-91 (1998).

tant.

### 5. Enforcement of Regulations

The creation of more severe insider trading regulations without an underlying dedication to the enforcement of these provisions, is insufficient to constitute a credible attack on insider trading. Whatever the elements of substantive insider trading regulations, these laws will only be effective if they are enforced by national governments or regulatory agencies. A country's national philosophy regarding insider trading will also play a substantial role in the extent to which illegal trading regulations are enforced.<sup>162</sup>

United States insider trading laws, and the EU Directive, share several structural similarities. However, in contrast to the widespread application of the United States insider trading laws, only limited action has been taken pursuant to the EU Directive. In part, this may be explained by the fact that, until very recently, several European countries have rarely sanctioned insider trading activity.<sup>163</sup> Even with the newly enacted changes in EU law, this underlying philosophy may remain an obstacle to the effective enforcement of illegal trading. Not until EU countries make insider trading regulation a national priority, and change their enforcement policies to reflect this commitment, will this activity be successfully deterred.

Jurisdictional barriers often inhibit the enforcement efforts of regulatory authorities.<sup>164</sup> This is evidenced by the growing number of insider trading cases which involve extraterritorial elements.<sup>165</sup> Currently, neither the United States nor the EU appear to be able to harmonize the exact terminology of insider trading regulations. Definitional disharmony has led to another prevalent problem in determining whose definitions should apply to any international scheme of securities regulation. This dilemma is commonly referred to as the "race to the bottom."<sup>166</sup>

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162. See generally Lynda M. Ruiz, *European Community Directive on Insider Dealing: A Model For Effective Enforcement of Prohibitions on Insider Trading in International Securities Markets*, 33 COLUM. J. TRANSNAT'L L. 217 (1995).

163. See EU Directive, *supra* note 6. The EU Directive was adopted in 1989. See *id.*

164. See *id.* In the past, French and British insider trading investigations have been hampered by the alleged violator's use of foreign banks for the trading activity. See *id.*

165. See Mann et al., *supra* note 126, at 47. This is the greatest obstacle faced by the SEC in its enforcement efforts. See *id.*

166. See David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423 (1991) (discussing rules of incorporation in EU member states). The phrase "a race to the bottom," in the sense of a legislative trend toward the lowest common denominator, has been coined in the context of state competition for corporate charters in the United States. See *id.* at 423.

### B. Race to the Bottom?

During most of the 1980s, academic theoretical analyses of securities regulation generally dealt with reforms in the domestic disclosure regime. Discussion of the international aspects of securities regulation began in earnest only after the SEC issued its 1987 report on the internalization of securities markets.<sup>167</sup> The bulk of academic literature<sup>168</sup> considers regulatory diversity a component of international regulatory competition, with the familiar debate over the race to the bottom<sup>169</sup> (or top) now taking place in the international arena. In this respect, it is worth noting that no matter where such a race may be heading, the important point is that race dynamics could lead to convergence either at the top, or the bottom, among the racing jurisdictions.<sup>170</sup>

Several commentators reason that because the United States is “where the money is,” others should adapt to the rules of securities markets in the United States, thereby eliminating the need for the SEC to change current rules.<sup>171</sup> However, this reasoning over-simplifies the issue of securities regulation. First, a majority of United States securities laws were written at a

167. *See id.*

168. *See, e.g.,* Hazen, *supra* note 82, at 263; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997); Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207 (1996); Gunnar Schuster, *Extraterritoriality of Securities Laws: An Economic Analysis of Jurisdictional Conflicts*, 26 L. & POL'Y INT'L BUS. 165 (1994) (presenting an economic analysis of jurisdictional conflicts).

169. *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 857-60 (1983). *See generally* Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 HARV. INT'L L.J. 47 (1993); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

170. *See* Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411, 1466 (1995). The “race to the bottom” is a situation where markets compete by lowering standards in the hope that lower and more lenient standards will attract more trading. *See id.* at 1466 n.142. As a result, the general level of standards across markets keeps declining, and markets continue to lower their standards. A recent example of a race to the bottom was the relaxation of rules by the Paris Bourse (the French securities exchange market) in September of 1994. *See id.* This relaxation was done as an effort to regain part of the trading volume in French stocks that had migrated to London's securities market. On the Paris Bourse's trading system, where orders are executed according to pure price and time priorities, block trades were usually executed at a price within the bid-ask spread. *See id.* If executed at a price outside the spread, they had to satisfy all other orders already on the book with higher priority. This practice preserved priority rules and protected smaller investors. Traders, however, could circumvent these rules by trading French stocks on SEAQ in London, where rules were less strict. *See id.* The Bourse, trying to regain trading from London, relaxed its rules to allow both block trading outside the bid-ask spread and a substantial delay in the disclosure of block transactions. *See id.*

171. *See, e.g.,* James R. Silkenat, *Overview of United States Securities Markets and Foreign Issuers*, 17 FORDHAM INT'L L. J. S4 (1994) (explaining that foreign markets have been unable to handle the capital needs created by privatization and traditional corporate finance needs, and as a result, many companies have been driven to United States markets).

time when the United States securities market existed, more or less, in isolation.<sup>172</sup> The internalization of the world's securities market has created significant competition for the United States securities market.<sup>173</sup> The new challenge to the SEC exists in balancing the protection of the investor with its responsibility to maintain the competitive position of the United States in the securities market.<sup>174</sup> Second, attracting foreign issuers to the United States regulated market is very important.<sup>175</sup> More activity in the United States from abroad will create more jobs and conversion fees for the United States financial industry.<sup>176</sup> Moreover, this will enhance the likelihood that the United States will influence the regulation of securities markets in other areas of the world.<sup>177</sup> Specifically, the International Organization of Securities Commissions (IOSCO),<sup>178</sup> and the International Accounting Standards Commission (IASC),<sup>179</sup> are proof that the SEC realizes there is a real element of competition which faces the United States today.<sup>180</sup>

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172. See generally Michael G. Dailey, *Preemption of State Court Class Action Claims for Securities Fraud: Should Federal Law Trump?*, 67 U. CIN. L. REV. 587 (1999).

173. See Geiger, *supra* note 115, at 258-59; see also Michael D. Mann et al., *Developments in International Securities Law Enforcement and Regulation*, 29 INT'L LAW. 729, 730 (1995). The "internationalization of the world's securities markets is no longer a new phenomenon" due to advances in computer and telecommunications technology. *Id.* It is today possible to participate in a country's securities markets from almost anywhere in the world. See *id.* Because foreign markets are now easily accessible, this has helped to expand the investor base and offers the investor more markets to chose from. Just as electronic trading systems seek to become active participants in the United States markets, their United States counterparts seek access to foreign markets. See *id.*

174. See, e.g., Bevis Longstreth, *A Look at the SEC's Adaptation to Global Market Pressures*, 33 COLUM. J. TRANSNAT'L L. 319 (1995) (describing the SEC's accommodations to internalization).

175. See Geiger, *supra* note 115, at 265-70.

176. See *id.*

177. See generally Longstreth, *supra* note 174.

178. The International Organization of Securities Commissions (IOSCO) is a private organization encompassing representatives of securities regulators from over 100 countries, including the regulatory agencies of all the major financial centers. The IOSCO serves as the principal forum for the study and discussion of international securities regulation. See Division of Corporation Finance, Securities and Exchange Commission, *Current Issues and Rulemaking Projects*, 1138 PLI/CORP. 71, 116-18 (1999).

The SEC is involved in the process of developing international disclosure and accounting standards within the framework of the IOSCO. See *id.*

179. See *id.* at 117. The International Accounting Standards Commissions (IASC) is striving to complete a core set of international accounting standards for which the SEC has expressed its full endorsement. See *id.*

180. The argument has also been made that the United States securities market regulations are too strict and that this will deter foreign issuers from listing in the United States, thereby depriving United States investors of lucrative investment opportunities. See generally Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227 (1998); James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149 (1993) (discussing that as the globalization of securities markets accelerates, international cooperation in securities regulation grows in importance for regulators, lawyers, and practitioners). The outcome is a composite legal



Recently, in the United States, the SEC has taken several steps to reduce the disclosure requirements applicable to foreign issuers.<sup>181</sup> For example, foreign issuers that offer securities in the United States do not have to prepare their financial statements in accordance with the United States Generally Accepted Accounting Principles (GAAP).<sup>182</sup> Instead, foreign issuers may choose to use any comprehensive body of accounting principles. Also, since 1994, first time foreign registrants have been required to reconcile only the last two years of their financial statements.<sup>183</sup> Furthermore, foreign issuers are required to disclose only limited information on the compensation of both directors and officers.<sup>184</sup> Another important step the SEC has taken with regard to international securities disclosure was the adoption of the Multi-jurisdictional Disclosure System (MJDS).<sup>185</sup>

The SEC implemented additional rules which have had a significant impact on the internationalization of the United States securities market. These rules are evidence that the "race to the bottom" has already commenced. However, it is quite possible that what the SEC is realizing in this globalizing market, is that regulations must not rigidly follow a pattern of United States dominance. In particular, Regulation S<sup>186</sup> proves the new and necessary flexibility which will enable efficient financial exchange in international securities markets.<sup>187</sup> Regulation S limits the extraterritorial application of the Act of 1933<sup>188</sup> by eliminating the registration requirements for many

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system in which national regimes may either enhance or erode the regulatory objectives of the component regimes. See generally Manning Gilbert Warren III, *Global Harmonization of Securities Laws: The Achievement of the European Communities*, 31 HARV. INT'L L.J. 185 (1990). To effectively enforce a country's securities regulation regime domestically, regulators increasingly need cooperation from their foreign counterparts. See *id.* Generally cooperation among securities regulators is thus warranted for reasons that are beyond the standard argument for curbing a regulatory race for the bottom. See *id.*

181. See Longstreth, *supra* note 174, at 319 (detailed description of the SEC's accommodations to internationalization).

182. 17 C.F.R. § 210.4-01(a)(2) (1997).

183. See Geiger, *supra* note 115, at 317.

184. See *id.* at 288-90.

185. See Matthew F. Gorra, *On-Line Trading and United States Securities Policy: Evaluating the SEC's Role in International Securities Regulation*, 32 CORNELL INT'L L.J. 209, 236 (1998). Based on a reciprocity approach, the Multijurisdictional Disclosure System (MJDS) allows Canadian and United States issuers to satisfy each other's registration and disclosure requirements by complying with their own domestic requirements. See *id.*

186. See generally JAMES D. COX ET AL., *SECURITIES REGULATION CASES AND MATERIALS* 324-32 (2d ed. 1997). The SEC has recently taken steps to lessen the burden of overseas investment. See *id.* Regulation S, which embodies Rules 901-904, is one of these steps which provides a safe harbor for offshore distributions and resales of unregistered securities of United States and foreign issuers. See *id.*

187. See *id.* Regulation S outlines two main safe harbors for offshore transactions considered to be "without the United States." These are issuer offerings (Rule 903) and resales (Rule 904). See *id.* Regulation S defines an offshore transaction as merely not involving "directed selling efforts" in the United States. See *id.* Relative to most of the other SEC provisions, Regulation S is amorphous and intentionally broad. See *id.*

188. See Securities Act of 1933, 15 U.S.C. § 77a (1997).

offshore transactions.<sup>189</sup> Moreover, Regulation S provides greater predictability with regard to the application of United States securities laws to offshore offerings.

### *C. International Enforcement of Insider Trading Laws*

Technological advances have enabled the trading of United States securities to take place outside of the country.<sup>190</sup> As a result, much of today's illegal trading of United States securities is facilitated by the use of foreign brokers and institutions.<sup>191</sup> For example, both Dennis Levine and Ivan Boesky utilized foreign bank accounts to aid their illegal trading.<sup>192</sup>

As discussed, United States insider trading law is by far the most comprehensive in the world. Indeed, many countries have yet to impose insider trading laws at all. Absent the enactment of uniform prohibitions of this activity worldwide,<sup>193</sup> some traders will take advantage of the discrepancies by trading outside of nations imposing harsh penalties.<sup>194</sup> Therefore, despite existing jurisdictional and extraterritorial discovery limitations, international application of United States insider trading laws is essential to maintaining control over illegal insider trading activity.

#### *1. Jurisdictional Barriers to International Enforcement*

The United States Constitution requires that minimum standards be met before a United States federal court can obtain personal jurisdiction over an individual, and subject matter jurisdiction over a controversy. Acquisition of personal jurisdiction must meet the standards of due process,<sup>195</sup> and subject matter jurisdiction will be met if it is authorized by Article III and Congress.<sup>196</sup>

Questions of personal jurisdiction are raised when the SEC attempts to

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189. See Jacob, *supra* note 142, at 400.

190. See Michael Gruson, *The Global Securities Market: Introductory Remarks*, 1987 COLUM. BUS. L. REV. 303, 305-06 (1987). Other factors promoting internationalization of the securities markets include: domestic economic growth, the volatility of domestic financial markets, and the impact of national "political and economic philosophies" regarding securities regulation. *Id.* at 304-05; Michael D. Mann et al., *The Internet: Identifying and Responding to International Jurisdictional and Regulatory Compliance Issues*, 1046 PLI/CORP. 241, 243-47 (1998).

191. See Lauren D. Rosenthal, *Rule 10b-5 and Transnational Bankruptcies: Whose Laws Should Apply?* 61 FORDHAM L. REV. S321, S338-39 (1993).

192. See generally Richard J. Hunter Jr. & Anthony L. Loviscek, *Insider Trading Since Carpenter: The Misappropriation Theory and Beyond*, 41 HOW. L.J. 79 (1997).

193. See Licht, *supra* note 180. The cost of adopting uniform regulations, in addition to the varying market structures and philosophies, are major obstacles to the enactment of uniform regulations worldwide. See *id.*

194. See *id.*

195. See *World-Wide Volkswagen v. Woodson*, 444 U.S. 286, 291 (1980).

196. See U.S. CONST. art. III.

investigate or prosecute insider trading involving either foreign participants or foreign witnesses.<sup>197</sup> The Supreme Court has held that to obtain personal jurisdiction over a foreigner, due process requires that it be in keeping with “traditional notions of fair play and substantial justice.”<sup>198</sup> This requirement is satisfied when there has been a finding of sufficient “minimum contacts” between the foreign subject and the United States.<sup>199</sup> Thus, if a foreign issuer has “minimum contacts” with the United States, the court may exercise personal jurisdiction over the issuer. The Court’s requirement of “minimum contacts” will likely be satisfied by any continuous trading of United States securities, any trading conducted through United States accounts, or even by a single act that is directly related to the SEC’s claim.<sup>200</sup>

The preamble to the SEA of 1934 states that its provisions “provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails.”<sup>201</sup> Based upon an interpretation of this language, two tests have developed as the basis to establish subject matter jurisdiction in cases with extraterritorial elements. These two test are the “conduct” test and the “effects” test.

Pursuant to the “conduct” test, a court examines the location of the activities, and will determine whether the activity taking place in the United States is substantial in relation to the overall conduct.<sup>202</sup> The second test utilized to assert subject matter jurisdiction is the “effects” test. This test examines the impact that the activities in question have had in the United States. Where the effect is significant, subject matter jurisdiction may be extended.<sup>203</sup> The first case that applied the “effects” test was *Schoenbaum v. Firstbrook*.<sup>204</sup> In *Schoenbaum*, the Second Circuit asserted subject matter jurisdiction despite the fact that the conduct occurred outside of the United States and involved foreign investors.<sup>205</sup> The rationale of the court was that the trading of United States securities injured United States investors.<sup>206</sup>

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197. See Mann et al., *supra* note 126.

198. *Asahi Metal Indus. Co. v. Superior Court*, 480 U.S. 102, 113 (1987) (quoting *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

199. See *World-Wide Volkswagen*, 444 U.S. at 291.

200. See, e.g., *SEC v. Tome*, 833 F.2d 1086 (2d Cir. 1987) (acquiring personal jurisdiction over Tome, a foreign citizen who traded United States stock through foreign brokers but had other contacts with the United States unrelated to the trading activity).

201. *Hazen*, *supra* note 82, at 524-44.

202. See *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326, 1339 (2d Cir. 1972). The court held that “abundant misrepresentations” made to a United States citizen in the United States constituted substantial conduct even where the remainder of the activities transpired abroad. See *id.*

203. See *Asahi Metal Indus. Co.*, 480 U.S. at 102.

204. 405 F.2d 200, 206 (2d Cir. 1968).

205. See *id.* at 206.

206. See *id.*

## 2. Extraterritorial Discovery

Another significant barrier to extraterritorial enforcement of United States insider trading law surfaces when an SEC subpoena or request for information, conflicts with foreign secrecy or blocking laws. Some nations have adopted blocking laws requiring that specified information remain confidential to protect national interests.<sup>207</sup> These statutes safeguard national interests, and prohibit private parties from disclosing any information.<sup>208</sup> Application of these laws can frustrate an attempt by the SEC to gain access to information that may be vital to an insider trading case.

Faced with foreign secrecy or blocking laws, the SEC may resort to courts in the United States to compel production of the requested information pursuant to Rule 37 of the Federal Rules of Civil Procedure.<sup>209</sup> A court's decision to grant or deny an order to compel is often based upon consideration of the factors listed in Section 40 of the Restatement (Second) of Foreign Relations Law of the United States (Restatement of Foreign Relations).<sup>210</sup> In the landmark case of *SEC v. Banca Della Svizzera Italiana (BSI)*,<sup>211</sup> the court held that BSI could not use Swiss secrecy laws to avoid disclosure and application of United States insider trading laws.<sup>212</sup> In another case, the Supreme Court introduced a second balancing test focusing on the first factor of the Restatement of Foreign Relations.<sup>213</sup> This test merely weighs the importance of the requested discovery material against the interests of each nation.<sup>214</sup> The Court developed this test from Section 437(1)(c)

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207. See Lee S. Richards, *Legal Representation in the International Securities Markets: Representing Clients in Securities and Exchange Commission, Department of Justice or Self-Regulatory Organizations Proceedings Involving Foreign Citizens or Foreign Trading*, 693 PLI/CORP. 143, 180-88 (1990).

208. See *id.* Canada, France, and the United Kingdom are among the nations that have enacted blocking statutes. Bank secrecy laws make it illegal for a foreign bank to disclose information about its bank records without the customer's authorization. Secrecy laws may be waived by individual customers provided that this does not prejudice the rights of third parties to whom the bank owes a duty of secrecy. See *id.*

209. See FED. R. CIV. P. 37.

210. See RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 40 (1965). Focusing on international comity considerations, the criteria under the Restatement include: (a) the national interests of each country; (b) the hardship of inconsistent enforcement upon the individual; (c) the extent of the conduct in the foreign nation; (d) the nationality of the individual involved; and (e) the extent to which compliance will be achieved through enforcement. See *id.*

211. 92 F.R.D. 111 (S.D.N.Y. 1981).

212. Following Banca Della Svizzera Italiana's (BSI) refusal to reveal the names of its customers, the SEC moved for a motion to compel. BSI argued that the motion should be denied because BSI would be subject to civil and criminal penalties in Switzerland if it made these disclosures. See *id.* at 114. In granting the SEC's motion, the court stated that "a foreign law's prohibition of discovery is not decisive" on this issue. *Id.*

213. See *Societe Nationale Industrielle Aerospatiale v. United States*, 482 U.S. 522 (1987).

214. See *id.* at 543-44.

of the Restatement of Foreign Relations but did not state whether the analysis should be exclusive.<sup>215</sup>

Using a unilateral approach to achieve compliance with United States' laws, such as court-ordered compliance, is problematic for a number of reasons.<sup>216</sup> First, an order to compel may be ignored where compliance will subject a foreign institution to civil and criminal penalties in its own country.<sup>217</sup> Furthermore, this unilateral approach is time consuming, expensive, and strains international relations.<sup>218</sup>

### 3. *Bilateral and Multilateral Cooperative Approaches to International Enforcement*

Bilateral and multilateral approaches, consisting primarily of cooperative agreements between the United States and foreign countries, are a far better method for conducting successful extraterritorial investigations, and promoting transnational enforcement of insider trading regulations.<sup>219</sup> Cooperative agreements have increasingly become the SEC's method of choice for facilitating international enforcement of insider trading regulations.<sup>220</sup> These agreements provide methods for successful extraterritorial discovery by enabling the SEC to work around foreign secrecy and blocking statutes.<sup>221</sup> Furthermore, under these agreements, the SEC comports with notions of international comity by promoting cooperative regulatory efforts as opposed to forced regulation.<sup>222</sup>

The United States has entered into bilateral treaties regarding mutual legal assistance in criminal matters with several European countries, and the

215. *See id.* at 544 n.28.

216. *See, e.g., In re Sealed Case*, 825 F.2d 494 (D.C. Cir. 1987) (reversing contempt order against bank for refusal to respond to grand jury subpoena emphasizing that bank had acted in good faith throughout the proceedings).

217. *See id.*

218. *See generally* Michael J. Calhoun, *Tension on the High Seas of Transnational Securities Fraud: Broadening the Scope of United States Jurisdiction*, 30 *LOY. U. CHI. L.J.* 679 (1999).

219. *See* Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 *MICH. J. INT'L L.* 207, 236 (1999). A cooperative approach towards international enforcement of insider trading is preferable to unilateral action because it can better accommodate the different levels of regulatory control existing worldwide. For example, unilateral pressure to enforce strict insider trading laws in countries with less-developed regulatory structures could stifle the development of these nations' domestic markets. *See id.*

220. *See* Mann et al., *supra* note 126.

221. *See id.*

222. *See id.* The two forms of international cooperative agreements that are used to conduct insider trading investigations and prosecutions are (1) mutual legal assistance treaties for the production of evidence in criminal matters; and (2) memoranda of understanding. *See id.* Finally, legislative initiatives promoting international cooperation, in addition to meetings between national securities regulators, provide the opportunity for international communication and cooperation regarding worldwide regulation of securities trading. *See id.*

SEC has ensured that each of these treaties covers offenses of securities laws.<sup>223</sup> The principal shortcoming of such treaties is their bilateral nature, which limits their availability to the two named nations.<sup>224</sup> A second limitation is the requirement that the subject matter of the request for assistance be a crime in both nations. This is a significant obstacle to obtaining meaningful cooperation in insider trading investigations because the United States has promulgated more developed insider trading laws than other nations. Mutual legal assistance treaties also tend to have a limited scope, and their bureaucratic nature often makes obtaining compliance too time consuming to offer much help.<sup>225</sup>

In an effort to create a less formalized and therefore a more expeditious method for obtaining assistance in these cases, the SEC has entered into Memoranda of Understanding ("MOU") with several foreign countries.<sup>226</sup> MOUs promote mutual exchange of the information necessary to investigate violations of insider trading and other securities laws.<sup>227</sup> Each party to the MOU agrees to assist and cooperate with the investigations conducted by the other.<sup>228</sup> Further, MOUs provide for mutual assistance across a wide range of laws and regulations and expands the forms of assistance the regulators may provide.<sup>229</sup> Unlike a treaty, MOUs are not binding agreements.<sup>230</sup> While admittedly this means that neither party is strictly bound to cooperate, the informal character of the MOU in contrast to the mutual assistance treaties, facilitates their swift enactment and implementation.<sup>231</sup> MOUs also eliminate the requirement that the subject matter of the investigation be an illegal activity in both countries, a characteristic of many of the bilateral treaties.<sup>232</sup> Therefore, MOUs are particularly useful when the SEC is investigating activity that does not constitute an offense in the foreign nation. And most important, MOUs often provide broader coverage of securities offenses than do

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223. *See id.*

224. *See id.*

225. *See id.*

226. *See generally* Recent Actions Regarding Treaties to Which The United States is a Party, 27 I.L.M. 571, 574 (1988). In 1982, the United States entered into its first MOU with Switzerland, creating an official mechanism for requesting and obtaining information needed in SEC investigations of insider trading. *See id.* Within the EU, the United States has subsequently entered into MOU with the United Kingdom's Department of Trade and Industry; the Commission des Operations de Bourse of France; the Ministry of Finance of the Netherlands; and, most recently, with the Director General of Norway's Banking, Insurance, and Securities Commission. *See id.* Additionally, on September 25, 1991, the United States and the United Kingdom entered into a second, more comprehensive MOU. *See id.*

227. *See id.*

228. *See id.*

229. *See id.*

230. *See* Elliot M. Beard, *A Critical Analysis of the Effects of Colello v. Second International Securities Law Enforcement Agreements*, 7 DUKE J. COMP. & INT'L L. 271, 272-75 (1996).

231. *See id.*

232. *See id.*

treaties.<sup>233</sup>

Finally, in addition to international legislation, international organizations further enable cooperation among national securities regulators. For example, the IOSCO is continuously working with participating nations to create legislation facilitating further enactment of bilateral and multinational cooperative agreements between securities authorities.<sup>234</sup>

#### D. Cultural Distinctions

At the root of the difficulties facing United States investors in building a sufficient level of confidence to invest in the European market, is the very different approach to securities regulation from cultural and ideological perspectives.<sup>235</sup> The importance of cultural understanding of corporate structure has been pointed out by several scholars and finance experts. One expert noted that “[r]ather than using agency costs or contract theory or judicial doctrine to explain this or that feature as mitigating or reflecting managerial deviation from the maximization of shareholders’ wealth, we must consider the role of politics, history, and culture.”<sup>236</sup> Securities regulations are affected a great deal by cultural standards and norms. The cultural factors, coupled with the diversity of modern industrialized countries, complicates international enforcement efforts and suggests that nations are not ready to relinquish substantial control over such culture bound regulations.<sup>237</sup>

National sovereignty sentiment and cultural change constitute two primary components contributing to the differences and complications of harmonizing insider trading laws between the United States and the EU. Indeed, these two elements are often intertwined. It is precisely the strong sentiment of national authority which often resists change in the increasingly overlapping spheres of society, politics, and economy.

In spite of Europe’s transformation, the private law of the core member states remains guarded in the jealous hands of national institutions, and these institutions are quite conscious of their national character.<sup>238</sup> Furthermore, in spite of the effort to harmonize the “black-letter” law of different legal systems, and where possible, to bring them into uniformity, the procedural rules and judicial remedies of each member state retain diverse national features. Most of the arguments advanced by European national courts and lawyers against harmonizing private law are doctrinal. They claim that such interference breaches the internal doctrinal coherence of civil codes. From this as-

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233. See generally Joseph I. Goldstein et al., *Recent SEC Enforcement Developments*, 703 PLI/CORP. 389 (1990).

234. See *id.*

235. See generally Wegen, *supra* note 11; Nunes et al., *supra* note 11.

236. James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investors*, 21 BROOK. J. INT’L L. 1, 77 (1995).

237. See generally Sulger, *supra* note 8, at 237-38.

238. See Licht, *supra* note 180, at 280.

pect, securities laws generally cannot claim the same degree of doctrinal sophistication and coherence as those of the United States.<sup>239</sup>

With the rise of the subsidiarity principle in the EU, and in light of its forthcoming enlargements, there is a risk that insider trading rules in the EU will remain substantially ununified and country specific.<sup>240</sup> The admission of more member states (particularly from Eastern Europe) means higher diversity and subsidiarity means more deference to national and local preferences. The unwillingness to completely override domestic laws and regulations in the name of harmonizing insider trading laws among the European countries is reflected and paralleled by the difficulties accompanying the introduction of the Euro currency. For example, two EU member states, the United Kingdom and Denmark, chose not to participate in the implementation of the Euro currency for the time being.<sup>241</sup> The numerous obstacles associated with a reduction in national authority before the actual implementation of the Euro currency, clearly indicates the desire of several European countries to maintain a sense of sovereignty over their own economic markets. However, the EU member states are increasingly feeling the pressure to resign themselves to the role of business advocates instead of clinging to the traditional and exclusive governmental role.<sup>242</sup> Thus, the threat to national sovereignty constitutes one significant hurdle to harmonization of insider trading rules.

Closely connected to the opinion of national sovereignty is the issue of cultural change. Alterations in both social and cultural factors influence the path towards any scheme of securities regulation.<sup>243</sup> With the heightened sense of securities regulations as represented by the implementation of the EU Directive, a new financial and corporate psychology will likely surface in the European financial market.<sup>244</sup> However, before any attempt to harmonize securities markets between the United States and the EU succeeds, it will be necessary for the EU to achieve economic reconciliation from within.

### III. HARMONIZING INSIDER TRADING RULES: MUTUAL RECOGNITION

Admittedly, the EU Directive has introduced and harmonized relatively sophisticated insider trading laws throughout the EU. However, the EU Directive's approach to enforcement and penalties of relegating coercion to individual member states may fail to provide the hoped for deterrence.<sup>245</sup> In part, this is explained by the fact that the EU Directive merely sets out

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239. See *id.* at 229.

240. See Nunes et al., *supra* note 11.

241. See Bruce C. Bennett, *European Capital Markets: How Issuers Have Prepared for EMU*, 1090 PLI/CORP. 821, 824 (1998).

242. See Samuel Wolff, *New Developments in International Securities Regulation*, 23 DENV. J. INT'L L. & POL'Y 347, 417 (1995).

243. See *id.* at 598.

244. See *id.*

245. See discussion *supra* Part I.2.d.



guidelines to be followed. From a United States perspective, this manner of implementing insider trading regulations falls short of the necessary level of adherence, which would create the confidence and trust between two otherwise distinct financial markets. From a theoretical perspective, the concept of subsidiarity addresses the general need for an approach towards the harmonization of insider trading rules.<sup>246</sup>

In the structure of subsidiarity, a better understanding of each other's approaches to insider trading coupled with an increased tolerance towards the existing differences, will likely heighten the incentive of foreign investment. Subsidiarity, an already familiar concept, may provide some guidance with respect to understanding and reconciling varying levels of insider trading regimes. Subsidiarity implies that all actions in social and political life should be performed by the smallest possible unit.<sup>247</sup> In the context of the European community, this approach means that the EU "government" would do as little as possible, leaving most of the functions to the national, and perhaps, sub-national governments.<sup>248</sup> The idea is that as long as the constituent units (member states) act as they are expected, there is less need to impose rules and standards from the center.<sup>249</sup> Member governments within Europe are given ample room to determine the appropriate level of rights and regulations in the competitive economic environment. Policy decisions are made on a level as close as possible to the one on which they are implemented while remaining consonant with basic national principles.<sup>250</sup>

In an attempt to better harmonize insider trading regulations, application of the concept of subsidiarity may constitute one avenue to consider. First, the United States' unilateral approach, best demonstrated by the SEC's motions to compel, does not effectively impede insider trading.<sup>251</sup> Such unilateral action applies United States laws, and the SEC policy objectives, over conflicting foreign laws.<sup>252</sup> The disregard for national sovereignty results in the creation of blocking statutes, secrecy laws, and the disappearance of cooperation. Just as the United States does not want its policies hinging on the interests of other nations, it must recognize that foreign nations share a similar feeling.<sup>253</sup> If the United States continues to ignore the sovereign rights of nations, foreign nations will refuse to renegotiate and broaden their MOUs

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246. See KOLE & D'AMATO, *supra* note 7, at 59-69.

247. See *id.*

248. See *id.*

249. See *id.* The analogue of "full faith and credit" in the United States. See *id.*

250. See *id.*

251. See Andrew S. Brooslin, *Enforcing Insider Trading Laws: The Need for International Cooperation*, 20 SUFFOLK TRANSNAT'L L. REV. 397, 418 (1997). A Rule 37 motion would force a foreign institution to release records in violation of the law of the nation in which it is situated. See *id.*

252. See *id.*

253. See Caroline A.A. Greene, *International Securities Law Enforcement: Recent Advances in Assistance and Cooperation*, 27 VAND. J. TRANSNAT'L L. 635, 670 (1994).

with the United States<sup>254</sup> The ultimate goal is to agree on as much as possible, on the most essential elements of insider trading rules, and yet, at the same time, allow for the United States and the EU to coordinate the essentials of these goals by whatever means they find most efficient on a domestic level.

From a practical view, the benefits of MOUs should be more readily recognized and expanded upon. The cooperative nature of MOUs present an impressive foundation upon which to build a stronger and more cohesive series of agreements. Their existence demonstrates a transnational desire to halt insider trading,<sup>255</sup> especially because MOUs promote the mutual exchange information necessary for the investigation of insider trading.

### CONCLUSION

The EU Directive has admittedly introduced and harmonized relatively sophisticated insider trading laws throughout several European countries. However, specific provisions of the EU Directive have created uncertainties with regard to prohibiting countries from continuing a course of conduct substantially similar to past practices of indifference toward insider trading. The EU Directive's approach, largely modeled after the SEC regulations, may ultimately fail to provide the hoped for deterrence. Some of the factors which contribute to the incomplete success of the EU Directive include the United States' fear of lowered standards and requirements in securities regulation, difficulties in agreeing upon definitions within the area of insider trading, legal cultural distinctions, and intolerance. However, by relying more on procedures such as MOUs and the concept of subsidiarity, while at the same time demanding an increased tolerance of legal cultural differences, will perhaps offer an approach to viewing rules from two different continents in an increasingly harmonious context.

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254. *See id.* at 671.

255. *See id.* at 649-55.

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