Global Business & Development Law Journal

Volume 3 | Issue 1 Article 11

1-1-1990

A Comparative Analysis of the European Community Insider Trading Directive

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I. INTRODUCTION

Should insider trading be punished? One might argue that a true capitalistic economy is dependent upon inequalities among its participants.[1] An attempt to regulate and balance these inequalities may ultimately have an adverse effect on the economy, since capitalism is dependent upon inequalities.[2] Those who espouse this view would contend that insider trading is an acceptable practice because it is inherently founded on inequalities among market participants. Any regulations on insider trading may pose a threat to capitalism.

The European Community and the United States have rejected the view that attempts to regulate securities trading may hinder the economy.[3] Under either system, profiting from inside information at the expense of other investors poses a threat to the proper operation

1. B. RIDER & H. FFRENCH, THE REGULATION OF INSIDER TRADING xiii (1979) [hereinafter RIDER AND FFRENCH].
2. *Id.*
3. S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 875 (2d Cir. 1968). *See* COMMUNICATION FROM THE COMMISSION TO THE PARLIAMENT, AMENDED PROPOSAL FOR A COUNCIL DIRECTIVE COORDINATING REGULATIONS ON INSIDER TRADING - COMMON POSITION OF THE COUNCIL, COMMISSION OF THE EUROPEAN COMMUNITIES 2 (July 20, 1989) [hereinafter AMENDED PROPOSAL FOR COUNCIL DIRECTIVE], stating that "Insider trading, in which the insider takes advantage of privileged information to trade profitably in securities, is a threat to the proper operation and the development of securities markets." *See* Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code*, 21 PAC. L.J. 221, 222 (1990) [hereinafter Berger]. Professor Berger notes that "even though persistent arguments have been made by some economists that insider trading is good for the trading markets as a whole and should be permitted, the overwhelming reaction in fact has consistently been regarded as 'unfair' because it destroys the 'level playing field' among participants in the trading markets." *Id.*

of the securities markets because it undermines the equal opportunity of investors in securities transactions.[4] Regulating and sanctioning insider trading is intended to eliminate the inequalities inherent in a system where participants have unequal access to information.[5] Proponents of insider trading regulations argue that decreasing unequal access and use of material information will enhance investor confidence, thus creating a stronger and more active market.[6]

In 1957, the Treaty of Rome (Treaty) created the European Economic Community.[7] The primary purpose of the Treaty was to establish a community-wide economic market.[8] In order to achieve this market, the Treaty promulgates four objectives, one of which is the freedom of capital movement.[9] The Council Directive of November 13, 1989 was designed to aid in the fulfillment of the objective of freedom of capital movement.[10]

The European Community finance ministers adopted the Council Directive in order to harmonize insider trading laws throughout the European Community (EC).[11] The Directive, which will become ef-

4. PROPOSAL FOR A COUNCIL DIRECTIVE COORDINATING REGULATIONS ON INSIDER TRADING PRESENTED BY THE COMMISSION, COMMISSION OF THE EUROPEAN COMMUNITIES 2 (May 21, 1987) [hereinafter PROPOSAL FOR COUNCIL DIRECTIVE]. The Commission stated that

> [c]onsequently, insider trading, which enables persons with inside information to make gains at the expense of other investors, constitutes a threat to the proper operation of the securities markets, since it totally undermines equality of opportunity for investors and therefore also their confidence in those markets. If the proper operation of those markets is to be safeguarded, it is therefore essential to eliminate that threat through measures designed to prevent the use of inside information in securities transactions.

Id.

5. *Id.*

6. *Council Directive of 13 November 1989 Coordinating Regulations on Insider Dealing*, O.J. EUR. COMM. (No. L 334) 30, at preamble 1 (1989) [hereinafter *Directive*]. The entire text of the Directive is reprinted at Appendix I to this Comment. (footnotes omitted). *See* Berger, *supra* note 3, at 222.

7. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 3 [hereinafter EEC Treaty]. Currently, the European Economic Community is comprised of 12 Member States: Belgium, the Netherlands, Luxembourg, France, Italy, Germany, the United Kingdom, Ireland, Denmark, Greece, Spain, and Portugal. *Common Market in Profile*, 1 Common Mkt. Rep. (CCH) ¶ 101.07 (1987).

8. Note, *Toward the Unification of European Capital Markets: The EEC's Proposed Directive on Insider Trading*, 11 FORDHAM INT'L L.J. 432, 433 (1988) [hereinafter Note, *Unification.*].

9. EEC Treaty, *supra* note 7; Cruickshank, *Insider Trading in the EEC*, 10 INT'L BUS. LAW. 345, 345 (1982) [hereinafter Cruickshank]. The other three objectives are not directly relevant to the Insider Trading Directive.

10. *Directive*, *supra* note 6, at preamble.

11. *New EC Insider Trading Ban Extends to Secondary Insiders*, Corp. Couns. Weekly (BNA), at 4-5 (Nov. 29, 1989) [hereinafter *Insider Trading Ban*]. The Council contains representatives from each of the Member States. This body performs the legislative functions of the European Communities. Recent Development, *Insider Trading and the EEC: Harmo-*

fective on June 1, 1992,[12] was promulgated on the belief that the free flow of capital depends upon a smoothly operating market.[13] Investors must have confidence in the market in order for the market to function effectively.[14] Further, investor confidence is based partially upon the belief that all investors are on an equal footing with each other and that they will be protected from the improper use of inside information.[15]

Currently, within the EC, only Denmark, France and the United Kingdom have adopted legislation sanctioning the exploitation of inside information.[16] The other nine Member States have either voluntary regulations, or none at all.[17] The Directive is intended to coordinate rules and regulations at the Community Level.[18] By unifying the safeguards in the various securities markets, the EC will enhance the securities interpenetration of these markets[19] which is necessary for the development of a true unitary European securities market.[20]

This comment explores the meaning and effects of the Directive and its potential ramifications on the Member States. The analysis is divided into two parts. Articles 1 through 4 of the Directive are the primary articles pertaining to the imposition of restrictions. Part II of this comment analyzes and compares the Articles to the current United States statutory and common law regarding insider trading. The U.S. insider trading law is utilized as a guidepost because U.S. law provides the most highly developed regulations on insider trading.[21]

Part III of the comment analyzes the ramifications of the Directive's Article 13. Article 13 permits each Member State to "determine the penalties to be applied for infringement of the measures taken

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nization of the Insider Trading Laws of the Member States, 8 B.C. INT'L & COMP. L. REV. 151, 163 (1985). The European Economic Communities shall hereinafter be identified as the EEC.

12. *Insider Trading Ban*, *supra* note 11, at 4-5.
13. *Directive*, *supra* note 6, at preamble, ¶ 8.
14. *Id.*
15. *Id.* at ¶¶ 9, 10.
16. Note, *Unification*, *supra* note 8, at 438.
17. *Id.* Those Member States with voluntary regulations do not require market participants to abide by the regulations. *Id.* at 442-44.
18. PROPOSAL FOR COUNCIL DIRECTIVE, *supra* note 4, at 3.
19. *Id.*
20. *Id.*
21. RIDER & FFRENCH, *supra* note 1, at xiv. Anti-insider trading regulations originated in the United States, and the United States law has been used as a model in numerous other countries. *Id.*

pursuant to this Directive."[22] Through a comparative analysis of the current laws and attitudes towards insider trading among the Member States and in the United States, Part III addresses the potential lack of effectiveness of Article 13.[23]

II. Restrictions

The Directive contains three restrictions on insider trading. First, Article 2 prohibits an insider[24] from taking advantage of inside information in order to invest in securities related to that information.[25] This restriction applies whether the insider is benefiting himself or another, either directly or indirectly.[26] Second, Article 4 imposes this same restriction on tippees.[27] Third, Article 3 restricts insiders from disclosing inside information to third parties, and from recommending that third parties engage in securities transactions based on inside information.[28]

Two main areas of concern arise from these restrictions. The first area relates to the question of who is subject to the restrictions imposed on insiders and tippees. The second area involves a determination of what type of information is considered *inside information*. The analysis of these two areas entails a comparison between the Directive and statutorily and judicially developed insider trading laws in the United States.

A. Insiders and Tippees

1. Insiders

Article 2 characterizes an insider as a person who possesses information "by virtue of his membership in 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, profession or duties."[29]

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22. *Directive, supra* note 6, at art. 13.
23. *Id.* Article 13 of the Directive requires each Member State to "determine the penalties to be applied for infringement of the measures taken pursuant to [the] Directive." *Id.*
24. *See infra* p. 235 (insider analysis).
25. *Directive, supra* note 6, at art. 2, ¶ 1.
26. *Id.*
27. *Id.* at art. 4. *See infra* p. 242 (tippee analysis).
28. *Directive, supra* note 6, at art. 3, ¶ 1.
29. *Id.* at art. 2, ¶ 1.

In essence, Article 2 describes an insider as any person who, by reason of his professional position, is likely to have access to inside information.[30]

In the United States, the primary sources of insider trading restrictions have been Section 10(b) of the Securities Exchange Act of 1934[31] and Rule 10b-5[32] promulgated thereunder by the Securities Exchange Commission.[33] Rule 10b-5 prohibits "any person" from trading or recommending trading on the basis of inside information.[34] Subsequent common law has restricted the broadly termed "any person" categorization as pertaining solely to insiders and tippees.[35]

(a) United States - Chiarella

On May 18, 1980, the United States Supreme Court decided *Chiarella v. United States.*[36] The *Chiarella* decision changed prior law with respect to determining who should be considered an insider, and thus, be subjected to insider trading restrictions.[37] The defendant

30. *Id.*; PROPOSAL FOR COUNCIL DIRECTIVE, *supra* note 4, at 4.

31. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1970).

32. 17 C.F.R. § 240.10b-5 (1987).

33. Block, Barton & Babich, *SEC Litigation: Private Rights of Action for Illegal Insider Trading*, 15 SEC. REG. L.J. 299, 299 (1987). Section 10(b) of the Securities Exchange Act of 1934 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 - . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1970). The Securities and Exchange Commission promulgated Rule 10b-5 under Section 10(b). Rule 10b-5 provides:

> 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, (1) To employ any device, scheme or artifice to defraud, (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) 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 (1987).

For the purposes of this Comment, it is not necessary to discuss other theories of insider trading liability in the United States, including those arising under 17 C.F.R. § 240.14e-3 (1985).

34. A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5, § 66.02[a][i] at 3-451 (1989) [hereinafter JACOBS].

35. *Id.*

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

37. S. ARKIN, TRADING ON INSIDE INFORMATION - PROBLEMS OF DEFINING, DETECTING, PROSECUTING, AND DEFENDING INSIDER TRADING CASES 29-31 (1984) [hereinafter ARKIN].

in *Chiarella*, Vincent Chiarella, was a mark-up man for a financial printing company.[38] A portion of his employment responsibilities consisted of handling documents used in connection with tender offers and other acquisitions of targeted companies before the offers were publicly announced.[39] Through these documents, Chiarella was able to identify the targeted companies.[40] Based on information contained in the documents, the defendant purchased shares of the targeted companies, and after public announcement of the acquisitions, sold the shares at a profit.[41] The government, represented by the Securities Exchange Commission (SEC), subsequently brought a criminal suit for insider trading against Chiarella.[42]

The main issue in *Chiarella* was whether Chiarella should be regarded as an insider and thus, subject to the insider trading restrictions imposed by Rule 10b-5. The government argued that Chiarella was an insider, based on the holding in *SEC v. Texas Gulf Sulphur Company*.[43] In *Texas Gulf Sulphur*, the Second Circuit did not put a limitation on who was subject to the obligation of either abstaining from trading or disclosing the inside information possessed by that person,[44] nor did the court base its decision on a fiduciary concept. Instead, the court emphasized that its decision was "based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[45] Thus, *anyone* who possessed information, regardless of how that person obtained the information, was subject to the "disclose or abstain" rule.[46]

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38. *Chiarella*, 445 U.S. at 224.
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. S.E.C., 394 U.S. 976 (1969).
44. *Id.*
45. *Id.*
46. *Id.* The disclose or abstain rule relied on in *Chiarella* was derived from a Securities Exchange Commission decision. *Id.* at 227 (citing Cady, Roberts & Co., 40 S.E.C. 907 (1961)).

> [T]he [Securities Exchange] Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from [a]n affirmative duty to disclose material information [which] has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.

Id.

Deriving its argument from the holding in *Texas Gulf Sulphur*, the SEC focused on the fact that the defendant had greater than normal access to material information regarding the acquisition of targeted companies.[47] The SEC contended that Chiarella had defrauded his employer's customers by misappropriating confidential information from them.[48] The government further argued that Chiarella had engaged in fraud against the investors who sold him the targeted companies' securities when he used the misappropriated information for personal gain without public disclosure.[49] However, the government had failed to utilize these misappropriation theories when it presented its case to the jury, so the Supreme Court refused to consider the theories.[50]

The Supreme Court concentrated on the Second Circuit's holding, which took the "equal access to material information" rationale of *Texas Gulf Sulphur* to its logical conclusion.[51] The Second Circuit had concluded that anyone "who regularly receives material[52] nonpublic[53] information may not use that information to trade securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."[54] The Second Circuit further held that Chiarella obtained the material nonpublic information through his position as a financial printer and thus was prohibited from trading on the basis of this information.[55]

The United States Supreme Court, in an opinion written by Justice Powell, held that "a duty to disclose under Section 10b does not arise from the mere possession of nonpublic market information."[56] In order for a duty of disclosure to be found, a fiduciary duty, or other similar relationship of trust and confidence must exist between the party who possesses the information and the party who is entitled to the information.[57] Thus, the Supreme Court rejected the *Texas Gulf Sulphur* holding, and took a narrower approach, recognizing

47. Chiarella v. United States, 445 U.S. 222, 224 (1980).
48. *Id.* at 227-30.
49. *Id.* at 235.
50. *Id.* at 236.
51. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978). *See* D. LANGEVOORT, INSIDER TRADING REGULATION 55 (1988) [hereinafter LANGEVOORT].
52. *See infra* p. 248 (discussion of "material").
53. *See infra* p. 251 (discussion of "nonpublic").
54. *Chiarella*, 588 F.2d at 1365.
55. *Id.* at 1367-68.
56. Chiarella v. United States, 445 U.S. 222, 235 (1980).
57. *Id.* at 228. *See id.* at n.55 (description of a fiduciary; duty limited absent explicit evidence of Congressional intent).

that the presence of a fiduciary duty for failure to disclose was paramount when imposing liability.

Applying a fiduciary standard to the facts in *Chiarella*, the Court found that "no duty could arise from [Mr. Chiarella's] relationship with the sellers of the targeted company's securities, for [Chiarella] had no prior dealings with them. He was not their agent, not a fiduciary, and not a person in whom the sellers had placed their trust and confidence."[58] Although Chiarella knowingly received non-public information in his business capacity, he was not considered an insider because he had no fiduciary relationship with the sellers.

(b) The Directive: Application of Article 2 to the Chiarella *Facts: First Interpretation*

If Chiarella were to be decided under the Directive, presumably the outcome would be different from the U.S. Supreme Court's decision. Applying Article 2 of the Directive to the facts of *Chiarella*, the defendant possessed inside information[59] concerning tender offers and other acquisitions of targeted companies before that information was made available to the public. Furthermore, Chiarella obtained this information "by virtue of the exercise of his employment."[60]

Mr. Chiarella's conduct in deciphering documents in order to discover the identity of the targeted companies, buying shares of five different targeted companies, and subsequently selling the shares at a profit after the tender offer was announced, indicates that Chiarella had "full knowledge of the facts" as required by Article 2.[61] The Directive's requirement that the defendant must have actual knowledge of the facts is distinguishable from the requirement under U.S. law that an individual either know or should know that the information is nonpublic. The Directive's scope is narrower, since it applies only to those individuals who possess "full knowledge of the facts," not to those who should have full knowledge of the facts. In order for a plaintiff to bring a cause of action under the Directive, he or she must establish that the defendant actually knew of the facts, regardless of whether a reasonable person would have been aware of them.

58. *Id.* at 232-33.
59. *See infra* p. 247 (analysis of inside information).
60. *Directive*, *supra* note 6, at art. 2, ¶ 1.
61. *Id.*

Take for example, a janitor who is employed at a brokerage firm and stumbles upon material inside information while performing his janitorial duties, and later uses that information in securities trading. The janitor may have violated the knowledge requirement in *Chiarella*, but he has not necessarily violated Article 2 of the Directive. The janitor may be held to have violated *Chiarella* if a reasonable janitor under the same or similar circumstances would have known that the information was nonpublic. Under Article 2 of the Directive, where a janitor knows nothing about the significance of the securities which he comes across, that janitor may not be considered an insider since he did not have full knowledge of the facts. Therefore, sanctions may not be imposed upon the janitor for trading on the information obtained or for disclosing that information to a third party. Although the lack of a reasonable person standard in Article 2 is a significant difference between the Directive and the *Chiarella* requirement, the outcome under this set of facts is not affected since Chiarella had full knowledge of the facts. Mr. Chiarella intentionally deciphered the code to get at the information, indicating he knew the information was nonpublic and material.

Finally, Mr. Chiarella took advantage of the information he had obtained by purchasing securities of the targeted companies prior to public announcement of that information. Under the Directive, Mr. Chiarella would be considered an insider since he (1) had obtained the information by virtue of the exercise of his employment, (2) had full knowledge of the facts with respect to that information, and (3) took advantage of the information by purchasing securities based on that information. His trading actions would thus be subject to the restrictions and penalties imposed by the Directive.

The Directive does not explicitly require a person to have a fiduciary relationship in order for that person to be considered an insider.[62] Lack of a fiduciary duty requirement is the main difference between the Directive and the holding in *Chiarella*, bringing the Directive's definition of an insider closer to that used in the United

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62. *Id.* Article 2, ¶ 1 of the Directive prohibits any person who:

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

Id. There is a clear absence of a fiduciary duty element in this definition.

States prior to the *Chiarella* decision.[63] Judicial interpretation of Rule 10b-5 has subsequently evolved to impose a fiduciary duty element as a prerequisite to being branded an "insider."[64] Rule 10b-5 states that it "shall be unlawful for any person . . . 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."[65] The language which specifies fraud as a requirement for a finding of unlawful conduct is the basis for incorporating a fiduciary requirement into the insider definition under U.S. common law.[66] Article 2 of the Directive is completely devoid of language suggesting fraud as a basis for unlawful activity; therefore, subsequent judicial interpretation creating a fiduciary duty element is doubtful.[67]

(c) The Directive: Application of Article 2 to the Chiarella *Facts: Second Interpretation*

A second interpretation of Article 2 exists. Although Article 2 does not specifically define an insider, it applies to only three classes of persons who have access to information: members of "the administrative, management or supervisory bodies of the issuer;" holders of the issuer's capital; and those who gain the information through "exercise of his employment, profession or duties."[68] In all three categories, people who may be considered insiders have access to inside information through their professional positions. Generally, people who hold such positions are bound by certain fiduciary duties, including a duty of confidentiality.[69] Thus, one might infer a fiduciary duty requirement in classifying a person as an insider under the

63. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. S.E.C., 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907 (1961); ARKIN, *supra* note 37, at 24-27; LANGEVOORT, *supra* note 51, at 37-49.

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

65. 17 C.F.R. § 240 (1987) (emphasis added).

66. *Chiarella*, 445 U.S. at 235. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. . . . A duty to disclose under section 10(b) does not arise from the mere possession of nonpublic market information." *Id. See also* Note, *Securities - Insider Trading - The Effects of the New EEC Draft Insider Trading Directive*, 18 GA. J. INT'L & COMP. L. 119, 134 (1988), stating "[b]ecause the . . . Directive makes no mention of fraud, which is the basis for the incorporation of a fiduciary element into the United States definition, it appears unlikely that the fiduciary element will attach, for the definition is self-contained." *Id.*

67. *Directive*, *supra* note 6, at art. 2, ¶ 1.

68. *Id.*

69. *But see* Section II(A)(2)(c) *infra* p. 245 (holder of the issuer of capital may not be fiduciary).

Directive. This approach further narrows the scope of Article 2, and is not readily apparent from the Article's explicit language. The *Chiarella* facts, viewed under this interpretation of Article 2, would lend themselves to a similar conclusion to that reached by the Court in *Chiarella.*

2. *Tippees*

(a) The Directive

Article 4 of the Directive defines the prohibitions to be imposed on tippees.[70] It defines tippees as those who knowingly obtain information, directly or indirectly, from insiders.[71] Article 4 states that "[e]ach Member State shall 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 possesses inside information, the direct or indirect source of which could not be other than a person referred to in Article 2."[72] That is, the Directive treats a tippee as an insider when the tippee gets information which he knows is inside information directly or indirectly from an insider. Put another way, when a person has inside information which he knows the general public does not possess, he is subject to the restrictions of the Directive. The primary rationale for regulating tippee action under Article 4 is that as a result of a tippee's direct or indirect association with an insider, the tippee gains the same access to material information as does the insider.[73] The drafters of the Directive recognized the significant risk of individuals procuring information from insiders to benefit themselves[74] and thus extended potential liability to tippees.[75]

(b) United States - Dirks v. SEC

The current U.S. definition of a tippee is derived from the holding in *Dirks v. S.E.C.*.[76] In *Dirks*, the defendant was an officer of a broker-dealer who specialized in providing investment analyses to

70. *Directive, supra* note 6, at art. 4.
71. *Id.*
72. *Id.* at ¶ 1.
73. Amended Proposal for Council Directive, *supra* note 3, at 5.
74. Proposal for Council Directive, *supra* note 4, at 4.
75. *Id.*
76. Dirks v. S.E.C., 463 U.S. 646 (1983).

institutional investors. Ronald Secrist, an officer of Equity Funding of America, an insurance company, informed Dirks that Equity Funding of America's earnings were overstated due to fraudulent corporate activities. Secrist urged Dirks to investigate and publicly announce the fraud. Based on the information that Dirks received from Secrist and upon information that Dirks subsequently gathered, he informed his clients of the fraud to enable them to sell their Equity Funding stock before the fraud became public knowledge. After his clients sold their shares, Dirks publicly announced the fraud, and the value of the stock subsequently decreased.[77] Thus, due to the inside information provided by Dirks, his clientele avoided incurring losses.[78]

Justice Powell, again writing the majority opinion for the Supreme Court, extended the fiduciary relationship principle stated in *Chiarella* to tippee liability.[79] He emphasized that a fiduciary duty is the sole basis for "abstain or disclose liability."[80] The Court held that an insider owes a fiduciary duty to the shareholders when disclosing information to the tippee. When the insider discloses information to the tippee, the tippee knows or should know that there has been a breach of this fiduciary duty.[81] Thus, a breach of a fiduciary duty by an insider is a prerequisite to an imposition of liability on a tippee. Based on these facts, the Court found that Dirks was not liable as a tippee.[82]

Such a breach by an insider was not found in *Dirks*, and therefore no tippee liability could be found. Although the Court in *Dirks* found that Secrist was an insider, Secrist had no intention of either benefiting himself or Dirks. Thus Secrist had not violated his fidu-

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77. *Id.* at 650-52.

78. *Id.* at 649.

79. LANGEVOORT, *supra* note 51, at 168.

80. *Id.* The author states that "[a]fter *Chiarella*, it can safely be said that a person violates rule 10b-5 by trading on material nonpublic information without disclosing that information to the marketplace—the essence of the abstain or disclose theory—if and only if he owes a fiduciary duty to market-place traders." *Id.*

81. Dirks v. S.E.C., 463 U.S. 646, 660 (1983).

82. *Id.* at 665. The Court stated

> [i]t is undisputed that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirk's [sic] sources that he would keep their information confident. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their . . . duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors . . . .

Id. (footnotes omitted).

ciary duty to Equity Funding shareholders by providing Dirks with the inside information. Secrist's intention was only to expose the fraud. Without a breach by Secrist, "there was no derivative breach by Dirks."[83] Thus, Dirks could not be held liable for insider trading as a tippee.[84]

The *Dirks* rationale is distinguishable from the approach taken in Article 4 regarding tippee liability. Underlying the Directive's restriction on tippees is the rationale of avoiding inequalities in access to material information.[85] Tippee liability under *Dirks* is based on an extension of the fiduciary duty obligation of the insider.[86] Under *Dirks*, tippees are held liable because of their participation in the insider's breach of his fiduciary duty, which occurs when the insider discloses information to the tippee.[87]

It must be noted, however, that *Dirks* did not directly address liability with respect to remote tippees; tippees who receive information indirectly from an insider. Commentators have generally expressed three interpretations of *Dirks* with respect to remote tippees.[88] Under a strict interpretation of *Dirks*, the person conveying the inside information to the remote tippee must be an insider.[89] A broader interpretation of *Dirks* would impose a fiduciary duty on the tippee and create a chain of persons with a duty to disclose so long as it could be shown that each person in the chain: (1) was given the information expressly for the purpose of facilitating trading based on inside information, (2) knew that the information was material and not public, and (3) knew or had reason to know that it came to him as a result of some breach of duty by an insider.[90]

The last possible interpretation, the approach taken by the Directive, is to "base liability simply on a showing that the person came into possession of information that he knew was material and non-

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83. *Id.* at 666-67.
84. *Id.*
85. PROPOSAL FOR COUNCIL DIRECTIVE, *supra* note 4, at 4.
86. LANGEVOORT, *supra* note 51, at 118.
87. *Id.*
88. *See* JACOBS, *supra* note 34, § 66.02[a][ii][F] at 3-494.23; LANGEVOORT, *supra* note 51, at 143-46.
89. Dirks v. S.E.C., 463 U.S. 646, 660 (1983). *See* JACOBS, *supra* note 34, § 66.02[a][ii][F] at 3-494.23; LANGEVOORT, *supra* note 51, at 143-44 (interpretation would allow tippees to tip others without subjecting them to liability where insider only sought to benefit from initial tip).
90. LANGEVOORT, *supra* note 51, at 144 (case where insider relates inside information to friend, and friend tells another he has just received a hot tip from an insider).

public and which he knew or had reason to know was obtained via a breach of fiduciary duty by an insider."[91]

(c) Application of the Dirks *Facts to Article 4*

Dirks may have been analyzed differently under Article 4 of the Directive. The Directive encompasses a broader range of potential tippees than does the strict interpretation of *Dirks*. Under the strict interpretation of *Dirks*, the person conveying the inside information to the tippee must be an insider.[92] Under the Directive, the person conveying the information to the tippee does not necessarily have to be an insider since the tippee could receive the information indirectly from another tippee or from a third party. The first requirement of defining a person as a tippee under the Directive is met if a person receives inside information, the source of which can ultimately be traced to an insider.[93] This approach is similar to the third interpretation of *Dirks* stated above. The two additional requirements of the Directive are that the tippee must have "full knowledge of the facts," and he must benefit either "his own account or . . . the account of a third party, either directly or indirectly" by acquiring or disposing of the pertinent securities.[94]

Dirks may also have been analyzed differently under the Directive because of a potential difference in the fiduciary duty requirements. A fiduciary duty is not explicitly required to characterizing an insider as such under the Directive. Although some of the specified employment positions enumerated in Article 2 *seem* to be fiduciary positions,[95] not all are.[96] Although *most* of these positions seem to involve a fiduciary relationship, what is meant by "holding in the capital of the issuer"[97] is not readily apparent. This language seems to apply to shareholders[98] who do not typically owe a fiduciary obligation to the issuer of the securities. Due to the lack of a fiduciary duty requirement in the second category of potential insiders, a fiduciary relationship may not be implicit in the Article 2 definition of an

91. *Id.* at 145 (situation where person overhears improper tip given by insider to tippee).
92. Jacobs, *supra* note 34, § 66.02[a][ii][F] at 3-494.23.
93. *Directive*, *supra* note 6, at art. 4, ¶ 1.
94. *Id.*
95. *Id.* at art. 2, ¶ 1.
96. *Id.*
97. *Id.*
98. Due to the explicit language of Article 2, it is not absolutely clear that the drafters intended this provision to apply solely to shareholders. Further, no legislative history is available concerning where this category originated.

insider. To further support the argument that a fiduciary relationship is not required in Article 2's definition of an insider, the Directive specifies only certain positions without using the word "fiduciary." This may imply that the drafters did not intend to require a fiduciary duty in the Directive's characterization of an insider.[99]

This lack of a fiduciary duty makes the Directive broader than *Dirks*, since a wider range of people could be considered insiders and tippees. Further, the same rationale for distinguishing the judicial expansion of *insider* liability in the United States from potential judicial expansion of insider liability in the EC applies to potential judicial expansion of *tippee* liability in the EC. The basis of the fiduciary relationship requirement in the United States is founded in the specific language of Rule 10b-5 pertaining to *fraud*.[100] One cannot act fraudulently unless that person owes a fiduciary duty to the other person; or, put another way, finding a fiduciary duty is a prerequisite to finding fraudulent activity. In contrast, Article 4 is devoid of language suggesting fraud as an element for imposing liability. As a result, future judicial interpretation among the Member States is not likely to require a fiduciary duty element for an imposition of tippee liability.[101]

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99. Article 4 states:

> Each member state shall 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 possesses inside information, the direct or indirect source of which could not be other than a person referred to in Article 2.

Directive, *supra* note 6, at art. 4, ¶ 1. Neither Article 2 nor Article 4 contain any language suggesting a fiduciary duty requirement.

100. Rule 10b-5 provides, in part:

> 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, . . . [t]o 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 (1987) (emphasis added).

101. *Directive*, *supra* note 6, at arts. 2, ¶ 1, 4, ¶ 1. In the United States, several judicially created theories of imposing the existence of a fiduciary duty have been expounded. In footnote 14 of *Dirks*, the court confirmed the existence of "temporary" or "constructive" insiders. Under this theory, the basis for recognizing a fiduciary duty by an outsider of the corporation, such as an underwriter, or accountant, is that they have "entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." Dirks v. S.E.C., 463 U.S. 646, 656 n.14 (1983). In *United States v. Newman*, the Second Circuit applied the misappropriation theory. United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983). Under this theory, "misappropriation of confidential information by an employee gives rise to a breach of a duty to his employer and may constitute a fraud prosecutable under § 10(b)." ARKIN, *supra* note 37, at 35. Because it is unlikely that subsequent judicial interpretation will create a fiduciary duty requirement imposing the Directive's restrictions, these theories for finding a fiduciary duty are inapplicable to the situation presented by the Directive.

Applying Article 4 of the Directive to the facts of *Dirks*, the defendant, Dirks, would not be found to be a tippee.[102] Dirks had full knowledge that the inside information had not yet been disclosed to the public. In addition, Dirks used the information to benefit third parties, his clientele, by giving them the opportunity to divest their shares in Equity Funding before public disclosure. However, in order for Article 4 of the Directive to apply to the facts in *Dirks*, Dirks would have had to have received the inside information either directly or indirectly from an insider, as defined in Article 2.[103] In fact, Dirks obtained the inside information concerning fraudulent corporate practices from Secrist. Although Secrist obtained the information by virtue of his position as an officer of Equity Funding, he would not be considered an insider under Article 4 because he had no intention of benefitting either himself, Dirks, or Dirks' clientele.[104] Secrist's only intention in disclosing the inside information was to publicly expose the company's fraudulent activities. Further, Secrist could not be considered a tippee under the Directive, since he obtained the inside information through his role as an officer of the corporation, not directly or indirectly through an insider as required in Article 2.

B. Inside Information

1. The Directive - Generally

Article 1 of the Directive defines inside information as "information 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 a significant effect on the price of the transferable security or securities in question."[105]

In the United States and under the Directive, insider trading restrictions apply only when an insider or a tippee utilizes inside information. The issue is what is "inside information"? United States

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102. *Directive*, *supra* note 6, at art. 4.

103. *See id.* at art. 2.

104. *Dirks*, 463 U.S. at 666-67. Although Secrist obtained his information "by virtue of his membership of the administrative, management or supervisory bodies of the issuer," he did not "take 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 . . . securities . . . to which that information relates." *Directive*, *supra* note 6, at art. 2, ¶ 1.

105. *Directive*, *supra* note 6, at art. 1, ¶ 1.

judicial decisions reflect a general consensus that, at a minimum, inside information consists of material nonpublic information.[106]

2. *"Material"*

(a) United States

In *Basic v. Levinson*, the United States Supreme Court set forth the standard of materiality for Section 10(b) and Rule 10b-5.[107] In *Basic*, Basic Incorporated held several meetings with another company concerning the possibility of a merger. Both the media and the New York Stock Exchange questioned the company regarding unusual trading activity in Basic stock. Basic Incorporated responded by making three public statements denying the occurrence of any negotiations which might affect the stock's activity.[108] Shareholders of Basic who sold shares after the public statements but before the merger, brought a 10b-5 claim alleging that the merger negotiations constituted a material fact and that the public announcements were materially misleading.[109] The District Court granted summary judgment for Basic on the merits, holding as a matter of law that any misstatements were immaterial, since negotiations were not destined with reasonable certainty to become a merger agreement.[110] The United States Court of Appeals for the Sixth Circuit reversed the District Court's summary judgment, reasoning that although Basic was under no general duty to disclose its discussions, any statement the company voluntarily released could not be so incomplete as to mislead.[111]

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106. Pitt, Snyder & Caplan, *Liability for Insider Trading Under the Federal Securities Laws*, in 2 SEC. ENFORCEMENT INS. 217, 236 (1988) [hereinafter Pitt, Snyder & Caplan].

107. Basic, Inc. v. Levinson, 108 S. Ct. 978, 983 (1988). In *Basic*, the Supreme Court expressly adopted "the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context." *See* TSC Indus., Inc., v. Northway, Inc. 426 U.S. 438, 499 (1976). *See also* Pitt, Snyder & Caplan, *supra* note 106, at 255. The most frequently cited definition of materiality for federal securities cases is promulgated in *TSC Industries*. *TSC Industries* was not an insider trading case. The dispute involved a stockholder claiming that a proxy statement was "incomplete and materially misleading in violation of § 14(a) of the Securities Exchange Act of 1934." *TSC Industries*, 422 U.S. at 441. The Court 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." *Id.* at 449. "There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

108. *Basic*, 108 S. Ct. at 981.

109. *Id.* at 980-81.

110. *Id.* at 982.

111. *Id.*

The United States Supreme Court ruled that in order to fulfill the materiality requirement of a Rule 10b-5 claim, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[112] In addition, the Court held that materiality "depends on the facts and thus is to be determined on a case-by-case basis."[113]

The Supreme Court remanded this case to the Court of Appeals which held that materiality "is a function of the probability that the transaction will be consummated and [of the] significance [of the transaction] to the issuer of the securities."[114] Applying the Supreme Court definition of materiality, the appellate court found that Basic's public statements denying the merger negotiations substantially affected the activity of the stock, and were therefore material.[115]

(b) The Directive

The portion of Article 1's definition of inside information which requires a "significant effect on the price" of the security can be analogized to the materiality requirement stated in *Basic v. Levinson.*[116] Under both U.S. law and the Directive, inside information must be of some value to the reasonable investor. This qualification of reasonableness is important since it prevents the possibility of imposing penalties on those who have used inside information which is of no value to the reasonable investor.[117]

Although analogous, the Directive's "significant effect on the price requirement" is not equivalent to the materiality requirement under U.S. law. In contrast to the American concept of "materiality", the Directive's scope is narrower, in that it encompasses a smaller spectrum of information. The U.S. condition that information must be substantially likely to significantly alter "the total mix of information made available,"[118] is broader than the Directive's requirement that

112. *Id.* at 983.
113. *Basic*, 108 S. Ct. at 993.
114. Levinson v. Basic, 871 F.2d 562, 564 n.1 (6th Cir. 1989).
115. *Id.*
116. *Directive, supra* note 6, at art. 1, ¶ 1. *Basic*, 108 S. Ct. at 983.
117. Such a rule is not in conformity with the previously stated policy behind insider trading sanctions. One of the main policies behind insider trading sanctions is to prevent certain investors from having an unfair advantage over other investors. Berger, *supra* note note 3, at 222. An assurance that investors are on an equal footing instills in other investors a confidence in the market, thus increasing trading activity within the market. *Id.*
118. *Basic*, 108 S. Ct. at 983.

the information is likely to significantly affect the price of the security. Information may alter the total mix of information without significantly affecting the price of the pertinent security.[119]

Arguably, differences in the meaning and application of materiality between the Directive and U.S. law is insignificant. One commentator has argued that in order for information to be material, it "must be of the sort that will be important enough to the investing public to cause a price movement when it becomes publicly available."[120] However, even if this theory, which requires a fluctuation in price when the information is publicly disclosed, were accepted in the United States, a substantial difference between the two laws would remain. The Directive requires that the information, if disclosed, would have a *significant* effect on the price.[121] Although the Directive does not state how great the anticipated impact on price must be in order to be significant, the Directive's requirement apparently extends beyond the U.S. requirement of a mere "price movement."

When one considers the purpose of the Directive,[122] the Directive's qualification on inside information may be too narrow. The Directive's preamble discusses both the necessity of inspiring investor confidence in the market,[123] and of making every effort to ensure that the market operates smoothly.[124] Overly broad restrictions may inhibit market transactions by causing investors unnecessary apprehension of sanctions. However, a transaction would arguably be inhibited only when its legality was questionable in the first place. Thus, such an inhibition may be deemed desirable in discouraging legally questionable transactions. On the other hand, the Directive's "significant price movement" requirement may create an undesirable inhibition due to its seemingly narrow approach. The inhibition may decrease confidence in potential investors who regard the restrictions as impotent and unable to achieve the intended purposes of the Directive. This lack of confidence in the market is exactly what the Directive was designed to correct. Therefore, the Directive's narrow application may contribute to its ultimate ineffectiveness.

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119. *Directive, supra* note 6, at art. 1, ¶ 1.
120. LANGEVOORT, *supra* note 51, at 155.
121. *Directive, supra* note 6, at art. 1, ¶ 1.
122. *See supra* Introduction, p. 232.
123. *Directive, supra* note 6, at preamble.
124. *Id.*

3. *"Nonpublic"*

Under U.S. law, information is "nonpublic" if "it is not generally available to the investing public."[125] This requirement is similar to, but not synonymous with, the Directive's requirement that inside information be that "which has not been made public."[126] In the United States, courts have adopted the "efficient market hypothesis" to determine when information becomes public.[127] Under this analysis, once a significant number of investors obtain the information, the market price will reflect the significance of the information. At this point, the market will have internalized the information so that profitable insider trading is no longer possible.[128] In light of U.S. treatment of similar language,[129] it is highly likely that the Directive's broad language on this point will be judicially expounded upon. The efficient market hypothesis was a logical extension and interpretation of the nonpublic requirement in the United States. The similarity in language between the standards set forth in the United States and by the Directive requiring that information be nonpublic suggests that the EC will expound upon the notion of limiting insider trading restrictions to information "which has not been made public."[130]

4. *Application of* Basic *facts to the Directive*

In applying the Directive to the facts of *Basic v. Levinson*, the information concerning Basic's merger would be considered inside information under Article 1 of the Directive.[131] The merger information clearly had not been made public. In addition, in order to conceal the information from the public, representatives of Basic made several public announcements falsely denying the possibility of a merger. Judge Friendly of the Second Circuit Court of Appeals once stated that a transaction "in which [a small corporation] is bought or sold is the most important event that can occur in a small corporation's life, to wit, its death."[132] Under Judge Friendly's

125. LANGEVOORT, *supra* note 51, at 168.
126. *Directive, supra* note 6, at art. 1, ¶ 1.
127. LANGEVOORT, *supra* note 51, at 168.
128. *Id.* at 168-69.
129. *See id.* at 168 (discussion of nonpublic information).
130. *Directive, supra* note 6, at art. 1, ¶ 1.
131. *Id.*
132. SEC v. Geon Indus., Inc., 531 F.2d 39, 47-48 (2d Cir. 1976).

rationale, information of a merger is likely to affect the reasonable investor's decision on whether to acquire or dispose of securities issued by the merging corporation. As this type of information may be the most significant information in a corporation's history, it is likely to have a significant effect on the price of the merged company's securities and hence, be considered material. Under the Directive, the information in *Basic* would be considered "inside information" since the type of merger discussed above was the type contemplated by the parties.

III. SANCTIONS

A. The Directive

The Directive does not stipulate sanctions for violating the restrictions of the Directive. Article 13 of the Directive states that "[e]ach Member State shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive. The penalties shall be sufficient to promote compliance with those measures."[133] The European Council may have taken this deferential approach to assure adoption of the Directive by all twelve of the Member States, including those with indifferent sentiment towards insider trading.[134] However, by allowing each Member State to adopt its own set of individually distinct sanctions, Article 13 may create a loophole, giving Member States the opportunity to circumvent the Directive through inadequate deterrence. The Member States that currently do not offer trading protection are likely to impose inadequate sanctions with little or no deterrent effect. Thus, Article 13 can be seen as the Directive's weakest section. Furthermore, due to the failure of the Council to stipulate sanctions, several areas of concern arise.

B. United States - The Need for Effective Deterrence

Prior to 1984, criminal prosecutions for insider trading were rare in the United States.[135] Civil actions brought by the SEC were limited

133. *Directive*, *supra* note 6, at art. 13, ¶ 1.

134. Parliament took the view that Article 13 "did not go far enough, and that it was not sufficient to require that penalties be [imposed]; the penalties for insider trading in the different Member States had also to be harmonized." AMENDED PROPOSAL FOR COUNCIL DIRECTIVE, *supra* note 3, at 3. The Commission rejected the Parliament's suggestions to amend Article 13, stating that "harmonization of criminal penalties would cause not only political but also legal problems." *Id.* at 4. The Council agreed with the Commission, stating that "no matter how heavy penalties were they could never ensure absolute compliance with the measures taken under the directive." *Id.* at 6.

135. LANGEVOORT, *supra* note 51, at 18; Comment, *Treble Damages, Deterrence, and Their*

to seeking disgorgement of profits from past insider trading and seeking injunctive relief from potential future insider trading.[136] Coupled with the difficulty of establishing violations of insider trading restrictions, injunctions and forfeiture of profits were not seen as effective deterrents.[137] Many insiders believed the perceived benefits of insider trading outweighed its potential burdens.

The Insider Trading Sanctions Act of 1984[138] was an attempt by Congress and the SEC to rectify the ineffective laws regarding insider trading.[139] The 1984 Act amended the Securities Exchange Act of 1934[140] by adding Section 21(d)(2).[141] Section 21(d)(2) permits the court, in actions brought by the SEC, to impose a civil penalty of up to three times the profit gained or loss avoided on those who are found to have violated insider trading restrictions under the Securities Exchange Act.[142] Thus, the court feasibly could obtain both disgorgement of profits and treble damages, resulting in a monetary sanction of up to four times the original amount of profit obtained or loss avoided.[143] Although determining the amount of damages to impose rests in the discretion of the court, the legislative history of the Act indicates Congress' desire to impose maximum damages as the rule and not the exception.[144]

Continuing insider trading scandals after 1984 indicated that the 1984 Act was not effective in deterring violations of securities laws. In 1988, the SEC filed an extraordinarily large complaint against

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Relation to Substantive Law: Ramifications under the Insider Trading Sanctions Act of 1984, 20 VAL. U.L. REV. 575, 576 (1986) [hereinafter Comment, *Ramifications*] (in the past, the United States has had difficulty curbing insider trading offenses); Note, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 455 (1985) [hereinafter Note, *Critique*]. The lack of success of insider trading sanctions is evidenced by a continuously high rate of insider trading offenses. *Id.* at 462. *See also* Langevoort, *The Insider Trading Sanctions Act of 1984 and its Effect on Existing Law*, 1985 SEC. L. REV. 187, 189 [hereinafter Langevoort, *Insider Trading Sanctions*] (attributing problem to lack of effective means of deterrence).

136. Comment, *Ramifications*, *supra* note 135, at 576.

137. Langevoort, *Insider Trading Sanctions*, *supra* note 135, at 189.

138. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1265 (1984) (codified as amended at 15 U.S.C. §§ 78a, 78c, 78t, 78u, 78ff (Supp. II 1984)).

139. Comment, *Ramifications*, *supra* note 135, at 577.

140. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1987).

141. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1265 (1984) (codified as amended at 15 U.S.C. §§ 78a, 78c, 78t, 78u, 78ff (Supp. II 1984)).

142. Note, *Critique*, *supra* note 135, at 456. The treble damages penalty may be imposed in addition to any other penalty. Langevoort, *Insider Trading Sanctions*, *supra* note 135, at 195.

143. Langevoort, *Insider Trading Sanctions*, *supra* note 135, at 195.

144. *Id.* The legislative history indicated the difficulty of detecting insider trading and the need for stronger deterrence. *Id.* at 192-93. This legislative intent is based on the same rationale as that which prompted the Securities Exchange Act of 1984.

Drexel Burnham Lambert, Inc., charging the corporation with, among other things, insider trading violations.[145] One week after this suit was filed, the House of Representatives unanimously passed H.R. 5133,[146] a bill which was subsequently enacted as the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).[147]

The ITSFEA contained three main provisions which enhanced the remedies available under the Securities Exchange Act. First, the 1988 Act repealed Section 21(d)(2) of the Securities Exchange Act, and replaced it with Section 21A.[148] Section 21A imposes new responsibilities on those who control or employ inside traders or tippers, and maintains the prior responsibilities on the actual insiders and tippees.[149] The statute differentiates between controlling persons who are broker-dealers or investment advisors, and other types of controlling persons. Next, Section 21A(b)(1)(A) provides that a controlling person may be held liable for civil penalties if the Commission establishes that "such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts of constituting the violation and failed to take appropriate steps to prevent such acts before they occurred."[150] Under Section 21A(b)(1)(A), a controlling person may not indifferently close his eyes if he knows, or recklessly ignores, the likelihood of an employee trading on inside information.[151] Inherent in this concept is the requirement that controlling persons will establish adequate policies and procedures for the dissemination and use of material information.[152]

If a controlling person is a broker-dealer or investment advisor, he also may be liable under Section 21A(b)(1)(B).[153] Under this section, liability may be imposed if the Commission declares that

145. Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALB. L. REV. 893, 894-95 (1988) [hereinafter Aldave]. "Last year the company agreed to pay a $650 million dollar fine and pleaded guilty to six counts of mail and securities fraud. As part of the settlement, federal prosecutors required Drexel to dump Milken, who now faces a 98-count fraud and racketeering indictment." Greenwald, *Predator's Fall*, TIME, Feb. 26, 1990, at 46, 48.

146. Aldave, *supra* note 145, at 895.

147. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (to be codified in part at 15 U.S.C. §§ 78c(a)(50), 78o, 78tA, 78(u)(a), 78ii(c), 80b-1, 78ff(a), 35(c)) [hereinafter ITSFEA].

148. Aldave, *supra* note 145, at 905-06.

149. ITSFEA, *supra* note 147, at §§ 3(a)(2), 21A(a)(3); 102 Stat. at 4678.

150. Securities Act of 1933, 15 U.S.C.A. §§ 77a-78hh-1, 21A(b)(1)(A); LANGEVOORT, INSIDER TRADING REGULATION 215 (1989) [hereinafter LANGEVOORT 1989].

151. LANGEVOORT 1989, *supra* note 150, at 215.

152. *Id.* at 216.

153. Securities Act of 1933, 15 U.S.C. §§ 77a-78hh-1, 21A(b)(1)(B).

"such controlling persons knowingly or recklessly failed to establish, maintain or enforce any policy or procedure required under section 15(f) of this title or section 204A of the Investment Advisors Act of 1940 and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation."[154] Section 21A(b)(1)(B) requires securities firms to make a bona fide effort to curb insider trading.[155]

This section provides that the trading or tipping sanction "shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of [the] unlawful purchase, sale or communication."[156] The penalty imposed on the controlling person shall not exceed "the greater of $1,000,000 or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation."[157] Where liability is based on the controlled person's tipping, rather than trading, the profits portion of the penalty is based on trading by direct tippees, not remote ones. However, except for the limit imposed by the profit penalty, the exact amount of the penalty remains dependent on the relevant "facts and circumstances" of the case.[158]

Besides enhancing civil liability remedies, the ITSFEA also strengthens two other areas of insider trading law. The Act amends Section 32(a) of the Securities Exchange Act by increasing the criminal penalties for insider trading.[159] Under this amended section, penalties for any person who willfully violates any provision of the Act, or a rule or regulation thereunder, are increased from $100,000 to $1,000,000.[160] This amended section also increases the potential jail sentence from 5 to 10 years and increases the fine imposed upon nonnatural persons from $500,000 to $2,500,000.[161] Further, the Act

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154. *Id.* Section 15(f) provides:

> "every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer."

Id. at § 15(f). Section 204A of the Investment Advisers Act is an identical provision with respect to registered policies or procedures. LANGEVOORT 1989, *supra* note 150, at 218.

155. LANGEVOORT 1989, *supra* note 150, at 220.
156. ITSFEA, *supra* note 147, at §§ 3(a)(2), 21A(a)(2); 102 Stat. at 4678.
157. *Id.*
158. LANGEVOORT 1989, *supra* note 150, at 212.
159. ITSFEA, *supra* note 147, at § 4; 102 Stat. at 4680.
160. *Id.*
161. *Id.*

establishes an express private right of action for "contemporaneous" investors against traders, tippers and controlling persons who violate insider trading restrictions.[162] In broadly permitting a private right of action for contemporaneous investors, this amendment is conceptually the most far reaching change in law under the Insider Trading and Securities Fraud Enforcement Act of 1988.[163]

C. European Community Today - Differences Among the Member States

Based on existing laws in the twelve Member States, each country probably will adopt its own set of sanctions, separate and distinct from the other Member States. Currently, only the United Kingdom, France and Denmark have enacted insider trading statutes,[164] while the Federal Republic of Germany utilizes a set of voluntary rules.[165] Ireland, Belgium and the Netherlands have proposed insider trading legislation.[166] Spain, Portugal, Greece, Italy and Luxembourg have neither imposed voluntary nor mandatory restrictions, nor have they drafted legislative proposals designed to create restrictions.[167] If the Member States adopt diverse sanctions, the Directive may be rendered ineffective. In order to truly obtain adherence to the provisions of the Directive, minimum harmonization of the sanctions is necessary.

1. Member States with Existing Sanctions

(a) United Kingdom

Prior to 1980, the United Kingdom did not regulate insider trading.[168] Insider trading became a criminal offense in England when

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162. Section 20A(a) states:

> Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneous with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

Id. at § 20A; 102 Stat. at 4678.

163. LANGEVOORT 1989, *supra* note 150, at 242-43.

164. Note, *Unification*, *supra* note 8, at 438-47.

165. *Id.*

166. *Id.*

167. *Id.*

168. Comment, *Recent Developments in Insider Trading Laws and Problems of Enforcement in Great Britain*, 12 B.C. INT'L & COMP. L. REV. 265, 267 (1989) [hereinafter Comment, *Insider Trading Laws in Great Britain*].

the British government enacted the Companies Act of 1980.[169] In 1985, the Company Securities (Insider Dealing) Act was enacted.[170] The 1985 enactment consolidated prior insider trading laws and bolstered the laws by providing sanctions.[171] The 1985 Act imposed a maximum criminal penalty of two years imprisonment, or fine, or both.[172] Civil actions could be brought under the Financial Services Act of 1986.[173]

Although the United Kingdom has enacted several regulations restricting insider trading, it may not be able to effectively regulate insider trading, as the government may not be prepared to invest the necessary resources.[174] The British criminal justice system has been accused of failing to take the offense seriously.[175] Between 1980, when insider trading became potentially criminal, and mid-1988, only seven insider trading charges were successfully prosecuted.[176] Given Britain's history of failure to prosecute insider trading violations, enactment of the Directive probably will not motivate the British government to invest additional resources into the effort to curb insider trading. Without a guarantee that the other Member States also will impose a minimum level of sanctions, the British courts are equally unlikely to utilize the sanctions provided by the 1985 Act.

(b) France

France made insider trading a crime in 1970.[177] Under the Law of 1970,[178] sanctions consisted of imprisonment ranging from two months to two years, and/or a maximum fine of five million Francs or four times the gain.[179] Although civil liability was theoretically available,

169. Note, *Insider-Trading Liability in Great Britain and Singapore: Can Regulatory Harmonization Close the Floodgates to Fraud on the Internationalized Markets?*, 14 BROOKLYN J. INT'L L. 357, 363 (1988) [hereinafter Note, *Insider Trading in Great Britain & Singapore*].

170. *Id.* at 363-64.

171. *Id.*

172. Comment, *Insider Trading Laws in Great Britain*, *supra* note 168, at 280.

173. Financial Services Act, 1986, ch. 60, §§ 177-78; Barnard, *United Kingdom Financial Services Act, 1986: A New Regulatory Framework*, 21 INT'L LAW. 343 (1987).

174. Note, *Insider Trading in Great Britain & Singapore*, *supra* note 169, at 377.

175. *Id.*

176. Comment, *Insider Trading Laws in Great Britain*, *supra* note 168, at 283. By comparison, since 1981, the SEC has brought over 100 successful insider trading prosecutions. *Id.*

177. Tunc, *The Reform of French Insider Trading Law*, 4(5) THE COMPANY LAW. 205, 205 (Sept. 1983).

178. Law No. 70-1208 of 23 Dec. arts. 8 & 9 of the 1970 Law added a new art. 10-1 into the 1967 Ordonnance.

179. Wallace, *Who is Subject to the Prohibition Against Insider Trading: A Comparative Study of American, British and French Law*, 15 Sw. U.L. REV. 217, 227 (1985) [hereinafter Wallace].

it was not considered a practical alternative due to its technical difficulties, expense and uncertainty.[180] The impracticality of civil sanctions led to the enactment of the Law of 1983.[181] The Law of 1983 revised and strengthened many aspects of the prior French insider trading law.[182] One revision required that the minimum fine imposed must equal or surpass the amount of the insider's profit.[183] The 1983 reforms reflected the French government's recognition of the seriousness of the insider trading problem.[184] The Law of 1983 is analogous to the United States' Insider Trading and Securities Fraud Enforcement Act of 1988. Both laws were promulgated on the perceived need to crack down on insider trading, as well as the belief that existing restrictions and sanctions were inadequate. Due to its established attitude against insider trading, France is likely to comply with the Directive's Article 13 requirement that each Member State shall impose penalties "sufficient to promote compliance with" the Directive's measures.[185]

(c) Denmark

The final Member State with active insider trading legislation is Denmark. Insider trading legislation was introduced in Denmark in June, 1986.[186] Under the 1986 enactment, those who violate insider trading restrictions face an unlimited criminal fine.[187] The threat of imposing an unlimited fine may sufficiently sanction insider trading to effectively promote compliance with the Directive's restrictions. If so, Denmark's present legislation will have met Article 13 standards.[188] Thus, Denmark is likely to continue imposing its present stringent sanctions, thereby complying with the Article 13 requirements.

2. Member States with Voluntary Sanctions

(a) Germany

In the Federal Republic of Germany, the only existing means of restricting insider trading is the German Insider Trading Guidelines

180. *Id.* at 230-31.
181. Surya, *France - Strengthening the Laws on Insider Trading*, 5 THE COMPANY LAW. 244, 244 (Sept. 1984).
182. *Id.*
183. Wallace, *supra* note 179, at 231.
184. *Id.* at 233.
185. *Directive*, *supra* note 6, at art. 13, ¶ 1.
186. Note, *Unification*, *supra* note 8, at 442.
187. *Id.*
188. *Directive*, *supra* note 6, at art. 13, ¶ 1.

of July 1, 1976.[189] These guidelines are voluntary rules.[190] Submission to the model code usually is accomplished by means of private contract between companies and insiders belonging to those companies.[191] A review panel, composed of business and finance association representatives, determines whether a violation of the guidelines has occurred.[192] Because the guidelines are voluntary and nonstatutory, the review panel, upon finding a violation, is not permitted to impose criminal sanctions. The primary sanction available to the panel is that of awarding the insider's unjust profits to the company which suffered from the inside trading.[193] In extreme cases involving gross negligence, publication of the case without prior consent of the insider is permitted.[194] The effectiveness of the guidelines is further restricted by a dual statute of limitations within the German Act on Stock Corporations.[195] A company must exercise its claim for a transfer of the profits within either three months after it learns of the insider trading, or up to five years after the trading occurred.[196] If the company fails to do so within the statutory time period, it loses its claim, and disgorgement may not be imposed.[197]

The voluntary German Insider Trading Guidelines are an ineffective device to combat insider trading. Fewer than one quarter of all German stock corporations have adopted the German Insider Trading Guidelines.[198] Additionally, although a significant number of review panel investigations have been conducted, few have resulted in insider liability, often in spite of strong prima facie evidence of insider trading.[199]

In order to comply with Article 13, Germany will need to adopt mandatory insider trading sanctions. To deter insider trading, these sanctions must extend beyond existing sanctions available to the review panel. Merely returning unjust profits is an insufficient deterrent to insider trading, particularly when one considers the potential

189. Blum, *The Regulation of Insider Trading in Germany: Who's Afraid of Self-Restraint?*, 7 Nw. J. Int'l L. & Bus. 507, 516 (1986) [hereinafter Blum].
190. *Id.*
191. Hopt, *The German Insider Trading Guidelines - Spring-Gun Or Scarecrow?*, 8 J. Comp. Bus. & Cap. Mrkt. L. 381, 383-84 (1986) [hereinafter Hopt].
192. *Id.*
193. *Id.*
194. *Id.*
195. German Act on Stock Corporations (Aktiengesetz), § 88 (3) (Sept. 6, 1965, as amended).
196. Hopt, *supra* note 191, at 388-89.
197. *Id.*
198. Note, *Unification*, *supra* note 8, at 444.
199. Blum, *supra* note 189, at 524.

monetary benefits which may be derived from insider trading.

The current attitude towards insider trading and the Directive aggravates the difficulty of effectively revising insider trading laws in Germany. A large majority of companies have refused to adopt the guidelines, indicating a renunciation of insider trading law by the business community.[200] In addition, a number of authorities have expressed their skepticism towards adopting mandatory legal sanctions.[201] Indeed, Germany's leary attitude towards insider trading may have partially motivated the Council to exclude a provision mandating sanctions in the Directive.

Although Germany conceivably could adopt statutory sanctions necessary to comply with Article 13,[202] it also may create statutes which are little more than a facade of legislative lip service. The sole purpose of adopting the sanctions may be to appease the other Member States, without any intention of utilizing the sanctions to their full extent. By 1986, ten years after the inception of the Insider Trading Guidelines, the review board had failed to find a single significant violation; this ten-year record demonstrates a realistic possibility that future German securities law will pay only lip service to the Directive.[203]

(b) The Netherlands

In the Netherlands, pressure to penalize insider trading increased in the early 1980s.[204] During this period securities trade increased, new financial markets were developed, the EC Directive was proposed, and other Member States had either created or toughened their insider trading sanctions.[205] Responding to these changes, the Netherlands, in January, 1987, adopted a self-regulating insider trading directive to govern the Amsterdam Stock Exchange (ASE), the Netherlands' only official stock exchange.[206] Limited both in scope and power, this model code is similar to the German Insider Trading

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200. Hopt, *supra* note 191, at 392-93.

201. One of these authorities is Judge Kissel, former president of the Board of Inquiry of the Frankfurt Exchange. Judge Kissel warned that "enforcement of an insider trading law by a state agency or by the courts would be completely inefficient." Blum, *supra* note 189, at 528.

202. Hopt, *supra* note 191, at 393-94.

203. Blum, *supra* note 189, at 524.

204. van Welsen, *The Netherlands - Proposed Changes in Dutch Securities Regulations*, 10(5) THE COMPANY LAW. 119, 120 (May 1989) [hereinafter van Welsen].

205. *Id.*

206. *Id.*

Guidelines. The model code applies only to members, employees and listed companies,[207] and its enforcement powers extend only to a limited group of potential insiders.[208] During an insider trading investigation, the ASE may not compel cooperation from outsiders.[209]

Presently, legislation has been proposed which would make insider trading a criminal offense in the Netherlands.[210] If passed, this legislation will apply to all three stock exchanges operating in the Netherlands.[211] The proposed legislation may be analogized to the United States Insider Trading and Securities Fraud Enforcement Act of 1988. Both statutes were created due to a heightened awareness of insider trading and a perceived need to deter the offense through harsher sanctions.[212] Several of the sanctions imposed in the United States are similar to the sanctions mandated under the Netherlands' proposed legislation. The Netherlands' proposed sanctions include a fine of up to NLG 100,000 for physical persons, and NLG 1,000,000 for corporations.[213] If the profit gained from the insider trading exceeds the statutory fine amount, the offender may be liable for up to four times the profit made.[214] The Dutch legislation also permits

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207. *Id.*

208. *Id.*

209. van Welsen, *supra* note 204, at 120.

210. *Id.* The newly proposed legislation contains the following pertinent provisions:

> para. 1-The person who, while possessing inside information, undertakes or accomplishes a transaction in The Netherlands in securities which are listed at a state-supervised exchange, will, in case an advantage can result from the transaction, be punished with a prison sentence of two years and a fine of the fifth category, or one of these penalties.
>
> Inside information is the knowledge of a particularity about the corporation or joint stock company to which the securities relate, or about the trade in the securities:
>
> (a) of which the person possessing knowledge of the particularity knows or, on the basis of reasonableness, should suspect that it is not public, and that it could not come, or has not come outside the group of persons bound to keep the secret without violation of this secret and
>
> (b) of which the disclosure, as can reasonably be expected, will affect the price of the securities.
>
> para. 2-With the same penalty will be punished the person who, while possessing inside information, undertakes or accomplishes a transaction from The Netherlands in securities listed at an exchange situated outside The Netherlands, if an advantage can result from the transaction.
>
> para. 3-Not punishable is the intermediary who, only possessing inside information relating to the trade in securities, transacts through the exchange in accordance with the rules of good faith, as to serve its principal.

Id. (citing the unofficial translation of art. 366(a) of the Penal Code).

211. *Id.* at 121. The three stock exchanges in the Netherlands are the Amsterdam Stock Exchange, the Amsterdam Financial Futures Market, and the EOE.

212. *See* Comment, *Ramifications*, *supra* note 135, at 577; van Welsen, *supra* note 204, at 120.

213. van Welsen, *supra* note 204, at 120.

214. Note, *Unification*, *supra* note 8, at 445.

the Amsterdam Public Prosecutor to impose a two year prison sentence.[215] The possible success of the proposed Dutch legislation in deterring insider trading sufficiently to comply with Article 13 is difficult to predict.[216]

(c) Belgium

Present law in Belgium does not forbid insider trading.[217] Currently, the regulation of securities markets in Belgium is monitored by several public bodies, including the Listing Committee, the Stock Exchange Commission and the Banking Commission.[218] The Banking Commission is an independent government agency which supervises a large portion of the private financial sector.[219] Recognizing the problems caused by insider trading, the Banking Commission has repeatedly condemned it as an unfashionable and unethical business practice.[220] Although the Commission has a wide range of regulatory power over the securities and banking industries, it has not utilized this power to curb insider trading.[221] The Commission's main deterrence efforts have consisted of recommendations to the industry to adopt higher standards of practice.[222] Failure to enforce these recommendations is due to the recommendation's lack of a clear legal basis.[223]

Belgium has been considering the implementation of insider trading legislation since the late 1970s.[224] The proposed legislation is partially attributable to an effort to conform Belgian law to the EEC's Directives.[225] Under the proposed legislation, insider trading is considered a criminal act for which offenders are subject to sanctions, including imprisonment for up to one year and a maximum fine of 40,000B.fr.[226] Insiders also may be civilly liable for any profits realized or loss avoided due to the insider trading.[227] If enacted, this

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215. van Welsen, *supra* note 204, at 120. The prosecution of insider dealing cases will generally be the task of the public prosecutor in Amsterdám due to a change in the Penal Procedure Code. *Id.*
216. *Directive*, *supra* note 6, at art. 13, ¶ 1.
217. E. WYMEERSCH, BELGIUM - BOOKLET 1: COMMENTARY, 1 INT'L SEC. REG. 20 (R. Rosen ed. 1988) [hereinafter WYMEERSCH].
218. *Id.* at 5.
219. *Id.*
220. *Id.* at 5, 20.
221. RIDER & FFRENCH, *supra* note 1, at 254-55.
222. *Id.* at 254.
223. WYMEERSCH, *supra* note 217, at 20.
224. *Id.*
225. *Id.*
226. Note, *Unification*, *supra* note 8, at 445.
227. *Id.*

legislation certainly would provide more effective deterrence of insider trading. Whether the proposed sanctions are sufficiently stringent to force compliance with the Directive remains to be seen. These sanctions are less threatening than both the proposed Netherlands sanctions and the existing French sanctions. Even though Belgium imposes a one year imprisonment sanction, its monetary sanction may prove inadequate. Limiting the fine for violation of insider trading restrictions may decrease the Directive's potential to deter insider trading.

3. Member States Without Insider Trading Sanctions: Ireland, Luxembourg, Portugal, Italy, Spain, and Greece

The remaining six Member States, Ireland, Luxembourg, Portugal, Italy, Spain, and Greece, do not regulate insider trading; only recently has Ireland proposed legislation prohibiting insider trading.[228] The lack of existing or proposed restrictions in these five Member States is indicative of their indifference towards insider trading.

The Member States with inadequate sanctions may attempt to evade compliance with Article 13 of the Directive, and the language of this article may be sufficiently vague so as to enable these Member States to do so. The Directive does not stipulate in what fashion the Member States are to determine when sufficient compliance has been achieved. Furthermore, because each Member State is permitted to determine its own sanctions, the question arises whether each Member State has exclusive power to determine if sufficient compliance exists.

D. The Need for a Uniform Minimum Level of Sanctions

Article 13 is the Directive's Achilles heel. It enables Member States such as Germany, Italy, and Portugal to avoid meaningful deterrence of insider trading. By failing to adopt and enforce effective sanctions, these Member States have impliedly consented to the continued practice of insider trading. The resulting inefficiency of the Directive in these countries inhibits the free flow of capital, one of the primary purposes of the 1957 Treaty of Rome.[229]

If the Member States genuinely believe in the premise of the Directive, that insider trading must be deterred in all Member States because it inhibits the free flow of capital, the European Community

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228. *Id.* at 445-46. These current proposals have not yet been published. *Id.* at 445

229. Cruickshank, *supra* note 9, at 345. *See supra* notes 7-10 and accompanying text (discussing Treaty of Rome).

eventually must adopt a uniform minimum level of sanctions. In order to be effective, these sanctions should include both imprisonment and monetary fines. In considering a minimum level of sanctions, the proposed Netherlands legislation may be an acceptable model. The United States insider trading sanctions may also provide a workable model; however, the success of the U.S. sanctions in deterring insider trading is still uncertain. Both the United States and the Netherlands impose fines of up to four times the profit made or loss avoided due to the insider trading. The Dutch legislation also permits a maximum two year prison sentence for violating insider trading restrictions.[230]

Uniform minimum sanctions, established at a sufficient level throughout the EC, would eliminate the attraction of insiders to Member States with lenient sanctions, as well as the compulsion of other investors to invest only in those Member States with strict sanctions. An acceptable minimum standard of investor protection throughout the EC would achieve the initial aim of the Directive, thereby enhancing the free flow of capital throughout the Member States.

IV. CONCLUSION

The Directive imposes several restrictions on insider trading. Both insiders and tippees are prohibited from using inside information through securities investments to their benefit. The Directive also restricts insiders from conveying inside information to a third party, or recommending that a third party purchase or divest securities based on inside information. The scope of these restrictions is dependent upon determining who is subject to the restrictions as an insider or a tippee, and what type of data is considered inside information.

In determining who should be characterized as an insider or a tippee, the Directive differs from both U.S. law and a strict interpretation of *Dirks*, primarily because of an absence of a fiduciary duty requirement under the Directive. Based on this difference, the Directive's restrictions are more similar to U.S. law prior to the 1980 *Chiarella* decision and a broad interpretation of *Dirks* than to present United States law. In addition, judicial expansion of the Directive may take a different path than the evolution of defining insiders and

230. van Welsen, *supra* note 204, at 120.

tippees under Rule 10b-5. The fraud element, which was the catalyst in *Chiarella*, caused Justice Powell to subsequently infer a fiduciary duty in both the insider and the tippee definitions. In contrast, the Directive does not indicate that the Council intended fraud to be an element in defining insiders and tippees. This difference permits the Directive to encompass a broader range of activity than does United States law.

Both U.S. law and the Directive have included in their definitions of inside information a requirement that the information be nonpublic. The United States uses the efficient market hypothesis to define when information is considered nonpublic. Member States likely will adopt a similar hypothesis to determine whether information is nonpublic.

In addition to the nonpublic requirement, the United States also requires that the information be material in order to be considered inside information. *Basic v. Levinson* provides the mandate that "there be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." The Directive's definition of inside information contains a similar requirement. The information must "be likely to have a significant effect on the price" of the security. On this point, U.S. law encompasses a broader range of transactions by loosely requiring that the information affect the reasonable investor's compilation of information. On the other hand, the Directive requires that the information be likely to affect significantly the price of the security. This stricter requirement limits the Directive's scope, and as a result, ultimately may limit the effectiveness of the Directive.

Although the Directive's restrictions are somewhat comparable to the United States restrictions, the lack of harmonization of the sanctions renders the entire Directive ineffective for all practical purposes. The impetus behind the Council's decision to allow each Member State to impose its own sanctions was politically motivated. In order to gain acceptance by all the Member States, the Council was forced to allot enforcement power to each Member State. The extremely diverse approaches to insider trading which exist among the Member States will be reflected in their sanctions. The resulting lack of uniform sanctions will cause investors to become suspicious that the Directive has failed to put them on equal footing with other investors in other Member States. This lack of investor confidence will inhibit the interpenetration of securities markets in the Community. Enhancing the free flow of capital among the Member States was the intended purpose of the Directive, and it is this purpose which Article 13 frustrates.

Providing a minimum level of sanctions throughout the Member States is critical to the success of the Directive. Without effective deterrence, insiders and tippees will not comply with the Directive's restrictions, particularly when one considers the potential benefits gained from insider trading. If the EC truly believes in harmonizing insider trading laws throughout the Member States, it will impose a minimum level of sanctions. This minimum level should be sufficiently high to effectively deter insider trading.

*Zachary Joseph Winner**

* Special thanks to Professor Don Berger and Professor Kojo Yelpaala for their invaluable advice and assistance.

APPENDIX I
Council Directive of 13 November 1989
Coordinating Regulations on Insider Dealing

THE COUNCIL OF THE EUROPEAN COMMUNITIES, Having regard to the Treaty establishing the European Economic Community, and in particular Article 100a thereof,

Having regard to the proposal from the Commission, In Cooperation with the European Parliament,

Having regard to the opinion of the Economic Social Committee,

Whereas Article 100a (1) of the Treaty states that the Council shall adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their own object the establishment and functioning of the internal market;

Whereas the secondary market in transferable securities plays an important role in the financing of economic agents;

Whereas, for the market to be able to play its role effectively, every measure should be taken to ensure that market operates smoothly;

Whereas the smooth operation of the market depends to a large extent on the confidence it inspires in investors;

Whereas the factors on which such confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information;

Whereas, by benefiting certain investors as compared with others, insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the market;

Whereas the necessary measures should therefore be taken to combat insider dealing;

Whereas in some Member States there are no rules or regulations prohibiting insider dealing and whereas the rules or regulations that do exist differ considerably from one Member State to another;

Whereas it is therefore advisable to adopt coordinated rules at a Community level in this field;

Whereas such coordinated rules also have the advantage of making possible, through cooperation by the competent authorities, to combat transfrontier insider dealing more effectively;

Whereas, since the acquisition or disposal of transferable securities necessarily involves a prior decision to acquire or to dispose taken by the person who undertakes one or other of these operations, the carrying-out of this acquisition or disposal does not constitute in itself the use of inside information;

Whereas insider dealing involves taking advantage of inside information; whereas the mere fact that marketmakers, bodies authorized to act as *contrapartie*, or stockbrokers with inside information confine themselves, in the first two cases, to pursuing their normal business of buying or selling securities or, in the last, to carrying out an order should not in itself be deemed to constitute use of such inside information; whereas likewise the fact of carrying out such transactions with the aim of stabilizing the price of new issues or secondary offers of transferable securities should not itself be deemed to constitute use of inside information;

Whereas estimates developed from publicly available data cannot be regarded as inside information and whereas, therefore, any transaction carried out on the basis of such estimates does not constitute insider dealing within the meaning of this Directive;

Whereas communication of inside information to an authority, in order to enable it to ensure that the provisions of this Directive or other provisions in force are respected, obviously cannot be covered by the prohibitions laid down by this Directive,

ADOPTED THIS DIRECTIVE:

Article 1

For the purpose of this Directive:

1. 'inside information' shall mean information 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 a significant effect on the price of the transferable security or securities in question;

2. 'transferable securities' shall mean:

(a) shares and debt securities, as well as securities equivalent to shares and debt securities;

(b) contracts or rights to subscribe for, acquire or dispose of securities referred to in (a);

(c) futures contracts, options and financial futures in respect of securities referred to in (a);

(d) index contracts in respect of securities referred to in (a), when admitted to trading on a market which is regulated and supervised by authorities recognized by public bodies, operates regularly and is accessible directly or indirectly to the public.

Article 2

1.

Each Member State shall prohibit any person who:
— by virtue of his membership of the administrative, management or supervisory bodies of the issuer,
— by virtue of his holding in the capital of the issuer, or
— because he has access to such information by virtue of the exercise of his employment, profession 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.

2.

Where the person referred to in paragraph 1 is a company or other type of legal person, the prohibition laid down in that paragraph shall apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.

3.

The prohibition laid down in paragraph 1 shall apply to any acquisition or disposal of transferable securities effected through a professional intermediary.

Each Member state may provide that this prohibition shall not apply to acquisitions or disposals of transferable securities effected without the involvement of a professional intermediary outside a market as defined in Article 1 (2) *in fine.*

4.

This Directive shall not apply to transactions carried out in pursuit of monetary, exchange-rate or public debt-management policies by a sovereign State, by its central bank or any other body designated to that effect by the State, or by any person acting on their behalf. Member States may extend this exemption to their federated States or similar local authorities in respect of the management of their public debt.

Article 3

Each Member State shall prohibit any person subject to the prohibition laid down in Article 2 who possesses inside information 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*.

Article 4

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 possesses inside information,the direct or indirect source of which could not be other than a person referred to in Article 2.

Article 5

Each Member State shall apply the prohibitions provided for in Articles 2, 3 and 4, at least to actions undertaken within its territory to the extent that the transferable securities concerned are admitted to trading on a market of a Member State. In any event, each Member State shall regard a transaction as carried out within its territory if it is carried out within its territory if it is carried out on a market, as defined in Article 1 (2) *in fine*, situated or operating within that territory.

Article 6

Each Member State may adopt provisions more stringent than those laid down by this Directive or additional provisions,provided that such provisions are applied generally. In particular it may extend the scope of the prohibition laid down in Article 2 and impose on persons referred to in Article 4 the prohibitions laid down in Article 3.

Article 7

The provisions of Schedule C.5 (a) of the Annex to the Directive 79/279/EEC shall also apply to companies and undertakings the transferable securities of which, whatever their nature,are admitted to trading on a market as referred to in Article 1 (2) *in fine* of this Directive.

Article 8

1.

Each Member State shall designate the administrative authority or authorities competent, if necessary in collaboration with other authorities to ensure that the provisions adopted pursuant to this Directive are applied. It shall so inform the Commission which shall transmit that information to all Member States.

2.

The competent authorities must be given all supervisory and investigatory powers that are necessary for the exercise of their functions, where appropriate in collaboration with other authorities.

Article 9

Each Member State shall provide that all persons employed or formerly employed by the competent authorities referredc [sic] to in Article 8 shall be bound by professional secrecy. Information covered by professional secrecy may not be divulged to any person or authority except by virtue of provisions laid down by law.

Article 10

1.

The competent authorities in the Member States shall cooperate with each other whenever necessary for the purpose of carrying out their duties, making use of powers mentioned in Article 8 (2). To this end, and notwithstanding Article 9, they shall exchange any information required for that purpose, including information relating to actions prohibited, under the options given to Member States by Article 5 and by the second sentence of Article 6, only by the Member State requesting cooperation. Information thus exchanged shall be covered by the obligation of professional secrecy to which the persons employed or formerly employed by the competent authorities receiving the information are subject.

2.

The competent authorities may refuse to act on a request for information:

(a) where communication of the information might adversely affect the sovereignty, security or public policy of the State addressed;

(b) where judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the State addressed or where final judgment has already been passed on such persons for the same actions by competent authorities of the State addressed.

3.

Without prejudice to the obligations to which they are subject in judicial proceeding under criminal law, the authorities which receive information pursuant to paragraph 1 may use it only for the exercise of their functions within the meaning of Article 8 (1) and in the context of administrative or judicial proceedings specially relating to the exercise of those functions. However, where the competent authority communicating information consents thereto, the authority receiving the information may use it for other purposes or forward it to other States' competent authorities.

Article 11

The Community may, in conformity with the Treaty, conclude agreements with non-member countries on the matters governed by this Directive.

Article 12

The Contact Committee set up by Article 20 of Directive 79/279/EEC shall also have as its function:

(a) to permit regular consultation on any practical problems which arise from the application of this Directive and on which exchanges of view are deemed useful;

(b) to advise the Commission, if necessary, on any additions or amendments to be made to this Directive.

Article 13

Each Member State shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive. The penalties shall be sufficient to promote compliance with those measures.

Article 14

1.

Member States shall take the measures necessary to comply with this Directive before 1 June 1992. They shall forthwith inform the Commission thereof.

2.

Member States shall communicate to the Commission the provisions of national law which they adopt in the field governed by this Directive.

Article 15

This Directive is addressed to the Member States.
Done at Brussels, 13 November 1989.

For the Council
The President
P. BEREGOVOY