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COMPARING INSIDER TRADING IN THE UNITED STATES AND IN THE EUROPEAN UNION: HISTORY AND RECENT DEVELOPMENTS

MARCO VENTORUZZO
Bocconi University Law School
Penn State School of Law
Max Planck Institute Luxembourg

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ABSTRACT: In the European Union insider trading has been regulated much more recently than in the United States, and it can be argued that, at least traditionally, it has been more aggressively and successfully enforced in the United States than in the European Union. Several different explanations have been offered for this difference in enforcement attitudes, focusing in particular on resources of regulators devoted to contrasting this practice, but also diverging cultural attitudes toward insiders. This situation has evolved, however, and the prohibition of insider trading has gained traction also in Europe. Relatively few studies have however focused on the substantive differences in the regulations of the phenomenon, especially with respect to their underlying tenets. This work contributes to the debate by contrasting and comparing the "philosophy" of insider trading regulation in the U.S. and in Europe, putting them in an historical perspective and considering some very recent developments in this area of both sides of the Atlantic.

KEYWORDS: Insider Trading Regulation, Enforcement, Information, United States, European Union.

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1. Introduction

In the European Union insider trading has been regulated much more recently than in the United States, and it can be argued that, at least traditionally, it has been more aggressively and successfully enforced in the United States than in the European Union.[1] Several different explanations have been offered for this difference in enforcement attitudes, focusing in particular on resources of regulators devoted to contrasting this practice, but also diverging cultural attitudes toward insiders.[2] This situation has evolved, however, and the prohibition of insider trading has gained traction also in Europe.[3] Few studies have however focused on the substantive differences in the regulation of the phenomenon, especially with respect to their underlying tenets.[4] This work contributes to the debate by contrasting and comparing the "philosophy" of insider trading regulation in the U.S. and in Europe, putting them in an historical perspective and considering some very recent developments in this area of both sides of the Atlantic.

The overly complex structure of the regulation of insider trading in the United States under section 10(b) of the 1934 Exchange Act and Rule 10b-5 is largely the product of case law and administrative regulations enacted by the SEC. Its defining feature is the questionable theory embraced by the Supreme Court in the seminal *U.S. v. Chiarella* decision[5], pursuant to which insider trading requires the violation of a fiduciary duty. This notion has not only enormously complicated this important area of the law, but has also hindered enforcement actions and has led to the enactment of convoluted regulations to cover conducts that clearly conflict with the rationale of prohibiting insider trading. A more simple, elegant, and effective regulation would simply provide that anyone who

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[1] *See* Edward Greene – Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 371 (2013). *See* also Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63 (2002), discussing the "spreading prohibition" of insider trading; Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002); and John C. Coffee Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PENN. L. REV. 229, 263 ff. (2007), arguing the different level of enforcement in the area of financial regulation generally, and insider trading specifically, in the U.S. and in some European countries.

[2] Coffee, note 1, 371.

[3] Coffee, note 1, 371, reporting data on enforcement actions by the Financial Services Authority, the U.K. securities regulator.

[4] Coffee, note 1, passim.

[5] Chiarella v. U.S., 445 U.S. 222 (1980).

obtains material non-public information concerning an issuer or a security because of his professional activity, or misappropriates it, should either disclose it (when allowed) or abstain from trading, and that tippees aware of the material and non-public nature of the information received should also disclose it or abstain from trading. This regulatory approach, generally referred to as "parity-of-information" theory, is the foundation of the prohibition against insider trading in the European Union.[6] Interestingly enough, the parity-of-information theory was originally adopted also in the United States in the 1960s[7], only to be rejected by the Supreme Court in favor of the current fiduciary-duty based approach.[8] Some scholars have argued – and this Article concurs – that the U.S. should reconsider the virtues of the parity-of-information theory and enact a more straightforward and easily enforceable regulation of insider trading based on this theory.[9]

It should however also be noted that, notwithstanding the different theoretical underpinnings of insider trading in the U.S. and in Europe, the practical scope of the two systems are largely similar, especially in the most egregious cases, even if important differences still exist. In the U.S., however, this result is reached through an overly complex web of case law, legislation and regulation. The goal of this article is not to delve into the nitty-gritty details of insider trading regulation, but to offer a comprehensive overview of the approaches followed on the two sides of the Atlantic, while also discussing some recent and important statutory and case-law developments.

2. Insider in the U.S: From parity of information to breach of fiduciary duties, to misappropriation – and Section 16 (B)

2.1. Rule 10b-5 and Insider Trading: The Rise and Fall of the Equal Access to Information Theory

The prohibition of insider trading based on Section 10(b) of the Exchange Act and rule 10b-5 thereunder developed through a non-systematic and sometimes contradictory series of cases, legislative acts and S.E.C. regulations. For this reason, the current prohibition can only be properly understood in the light of its historical context. We will therefore adopt an historic perspective to examine the applicable rules.

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[6] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), 2003 O.J. (L 96) 16 [hereinafter Market Abuse Directive].

[7] See In the matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[8] Chiarella v. U.S., 445 U.S. 222 (1980).

[9] *Id.*, at 373 f.

A first starting point is that when in 1942 the S.E.C. enacted Rule 10b-5 under Exchange Act section 10(b), it did not explicitly address insider trading; the rule, in fact, does not even contain a reference to this type of conduct, but is a broad and general anti-fraud provision.[10] In relevant part, Rule 10b-5 makes it unlawful, for any person in connection with the purchase or sale of a security:

> "(a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made . . . not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person."[11]

The history of how the provision was introduced confirms that when the S.E.C. adopted it, it did not consider its possible application to insider trading.[12] Only in the 1960s the Commission started using rule 10b-5 to prosecute insider trading occurring on impersonal markets in an administrative procedure, *In re Cady, Roberts & Co.*[13]

In this case the director of a registered corporation, J. Cheever Cowdin, was also a partner of Cady, Roberts & Co., a stock brokerage firm.[14] In his capacity as director, Cowdin learned that the corporation was about to reduce its dividend, and shared this information with Robert M. Gintel, another partner of the brokerage firm.[15] Gintel sold his clients' shares of the corporation before the dividend cut was announced, thus avoiding significant losses they might have otherwise suffered.[16] The S.E.C. sanctioned Cady, Roberts & Co., arguing that a violation of Rule 10b-5 had occurred because Gintel traded while in possession of material, non-public information.[17] This was the first instance in which the Commission introduced the concept of "disclose or abstain", and was based on the principle of equal access to information, according to which trading on the basis of material, non-public information was fraudulent under Rule 10b-5.[18]

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[10] 17 CFR §240.10b-5 (1996).

[11] *Id.*

[12] See S.E.C. v. Texas Gulf Sulphur, 401 F.2d 833, 885 (2 Cir. 1968) (Moore dissenting)

[13] 40 S.E.C. 907 (1961). As noted by Roberta S. Karmel, *Outsider Trading on Confidential Information – A Breach in Search of a* Duty, 20 CARDOZO L. REV. 83 at 87, at common law insider trading on a stock exchange was not considered unlawful because directors were considered to only have a fiduciary duty to the corporation, not individual shareholders. Only non-disclosure of inside information in a face-to-face transaction could be considered illegal.

[14] 40 S.E.C. 907 (1961), at 908.

[15] *Id.*

[16] *Id.*

[17] *Id.* at 909.

[18] *Id.* at 911.

As indicated by Bainbridge, the precedential value of *Cady* was dubious, both because it was an administrative procedure, and because it concerned a financial intermediary operating in a highly regulated industry.[19]

A couple of years after, in 1963, however, the Second Circuit adopted the principle of equal access to information in *S.E.C. v. Texas Gulf Sulphur.*[20] The facts of this case, as with many other insider trading litigations, evoke the plot of a movie. In short, since 1959, Texas Gulf Sulphur began secretly to investigate the presence of precious minerals in an area in Ontario.[21] Employees of the corporation involved with the surveys were explicitly asked to keep information concerning the possible discovery confidential.[22] The surveys confirmed the presence of a rich ore deposit, and the corporation started acquiring land where the minerals could be mined.[23] In 1963, when the information was still secret, employees of Texas Gulf Sulphur began to buy stock or options on stock of the corporation and tipped outsiders about the possible appreciation of the shares of the corporation.[24] In fact, as news about the discovery began to become public, the price of the shares soared, granting to employees and their tippees a substantial profit.[25] The S.E.C. brought a suit against the insiders alleging a violation of Rule 10b-5.[26]

The Second Circuit court embraced the position of the S.E.C., holding that an insider in possession of material, non-public information, had to either disclose the information to the public or abstain from trading.[27] The rationale for this decision was, once again, a theory of equality of access to information, according to which insiders could not take advantage of undisclosed information and all investors should be granted a similar set of information when trading.[28]

This expansive notion of insider trading sent a shiver in financial and legal circles. The fear was that such a broad approach would result in unfair results that might hinder the development of active markets. When, seven years later, the

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[19] STEPHEN BAINBRIDGE, AN OVERVIEW OF INSIDER TRADING LAW AND POLICY: AN INTRODUCTION TO THE INSIDER TRADING RESEARCH HANDBOOK 5 (Edward Elgar Publishing Ltd., 2013) available at http://ssrn.com/abstract=2141457; see also e.g., Recent Decision, 48 VA. L. REV. 398, 403-04 (1962) ("in view of the limited resources of the Commission, the unfortunate existence of more positive and reprehensible forms of fraud, and the inherent problems concerning proof and evidence adhering to any controversy involving a breach of duty of disclosure, there is little prospect of excessive litigation evolving pursuant to [*Cady, Roberts*]").

[20] 401 F.2d 833 (2nd Cir. 1968).

[21] *Id.* at 843.

[22] *Id.* at 843.

[23] *Id.* at 844.

[24] *Id.* at 844-45.

[25] *Id.* at 847.

[26] *Id.*

[27] *Id.* at 848.

[28] *Id.* at 849.

Surpeme Court considered the issue in the seminal case of *Chiarella v. U.S.*, the justices rejected the equality of access to information approach and curbed its potentially broad reach.[29] In order to do so, the Court refused to accept that simply possessing material, non-public information imposed the duty to disclose or abstain, and required something more in order to find insider trading liability: a breach of a fiduciary duty owed by the insider to the investors with which he traded.[30]

2.2. Fiduciary-Duty Based Insider Trading

Even if well-known, the facts of *Chiarella* deserve a brief description. Pandrick Press, a financial printer that prepared tender offer materials for bidders, used codes to conceal the names of the corporations involved.[31] Notwithstanding this precaution, one of Pandrick's employees, Vincent Chiarella, managed to figure out the name of the target corporation in a tender offer and bought securities in the corporation before the bid was announced.[32] Obviously after the announcement the price of the shares of the target rose, and Chiarella sold them at a significant premium.[33] Chiarella was found guilty of illegal insider trading both by the district court and the court of appeals of the Second Circuit on the basis of the equal access to information theory.[34]

The Supreme Court, however, acquitted Chiarella, clearly stating that it refused to impose a general duty of all investors not to trade based on material, nonpublic information.[35] In order to incur in liability for insider trading, the defendant needed also to have a duty to speak based on a fiduciary relationship with the party on the other side of the transaction.[36] Pursuant to this view, Chiarella had no relationship with the shareholders of the target corporation from whom he bought the shares, and was therefore free to use the information he had.[37] According to this approach, in other words, for insider trading liability two conditions need to be met: (a) trading on the basis of material, nonpublic information; (b) and violating a fiduciary duty to the investors with which the

[29] 445 U.S. 222 (1980).
[30] *Id.* at 224-35.
[31] *Id. at* 224.
[32] *Id.*
[33] *Id.*
[34] SEC v. Chiarella, No. 77 Civ. 2534 GLG (S.D.N.Y. May 24, 1977); United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980). In fact, the facts of Chiarella can better be described as "outsider" trading, since the defendant was not an insider of the issuer and traded on the basis of what can be defined as "market information".
[35] 445 U.S. 232.
[36] *Id.* at 233.
[37] *Id*.

trade occurs. It follows that, for example, directors of an issuer might violate Rule 10b-5 by trading with their shareholders on the basis of inside information, but only because they owe them a fiduciary duty.

With this and the following decision, insider trading in the U.S. became indissolubly intertwined with the elusive concept of fiduciary duties, a circumstance that raised (and in many ways still raises) delicate legal issues, tension with other precedents, and a regulatory chase between the S.E.C. and judicial decisions in order to define the scope of the prohibition.[38]

Probably the best example of this struggle is the adoption by the S.E.C. of rule 14e-3 under section 14(e) of the Williams Act just six months after *Chiarella*.[39] Under the fiduciary duty theory introduced with Chiarella, supporters of a stricter regulation of insider trading clearly identified a void in the regulation of the phenomenon. To many it seemed unacceptable that Vincent Chiarella would escape liability; more generally, insider trading was basically not applicable in the context of tender offers. Non-insiders of the target who had access to information concerning an imminent tender offer could freely speculate on this information beating the market, because they had no fiduciary duties toward the shareholders of the target. The S.E.C. stepped in with rule 14e-3, which prohibits insiders of the bidder and target to tip confidential information on a tender offer, and any person possessing information on a tender offer from trading in the target's securities if substantial steps towards the commencement of the bid have been made.[40] It is important to point out that rule 14e-3 is applicable independently from any violation of fiduciary duties, in fact it completely ignores the issue of breach of fiduciary duties in order to effectively regulate insider trading in relationship to a tender offer.

Rule 14e-3, however, enacted under the Williams Act, only covers cases in which the acquisition technique is a tender offer.[41] Consider the situation in

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[38] *See* Karmel, *supra* note 13, at 107.

[39] Williams Act, Public L. No. 90-439 § 3(e), 82 Stat. 454, 457 (1968) (codified as amended at 15 U.S.C. § 78n(e) (1988)); 17 C.F.R. § 240.14e-3 (1990). See 45 Fed. Reg. 60,410 (1980). See Laura Ryan, *Rule 14e-3's Disclose-or-Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449 (1991).

[40] Doubts on the legitimacy of the rule are expressed in Jeff Lobb, *SEC Rule 14e-3 in the Wake of United States v. O'Hagan: Proper Prophylactic Scope and the Future of Warehousing*, 40 WM. & MARY L. REV. 1853, 1866 (1999).

[41] 15 U.S.C. § 78n(e) (1994), which in its entirety reads:

"It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and

which the buyer attempts to gain control of a target through acquisitions of shares on the open market, or through a proxy fight. In these instances, investors that are not in a fiduciary relationship with the target's shareholders and whoever becomes aware of the confidential information about the acquisition could be able to speculate without incurring in liability. This result seems inconsistent with rule 14e-3: the different treatment that these cases receive simply because of the different acquisition technique used does not appear fair or rationale. Rule 14e-3, while probably helpful to fill a void left open by *Chiarella* and the fiduciary-duty standard, is simply a patch of an otherwise incomplete and asystematic approach to insider trading.

In the wake of Chiarella, the Supreme Court decided in 1983 the second seminal case on insider trading, *Dirks v. S.E.C.*[42], this time dealing with the controversial issue of tippees' liability. Also in this case, the opinion written by Justice Powell remained entrenched on the idea that insider trading requires a violation of fiduciary duties.[43] The decision held that a tippee dealing on the basis of inside information can be liable only if (a) the tipper breached a fiduciary duty by disclosing the information and receiving a personal benefit from tipping, and (b) the tippee knows or has reason to know of the breach of the duty.[44] Dirks was coherent with Chiarella, but it also contributed to constrain the application of the prohibition against insider trading by requiring, as a pre-condition for the violation, a breach of a fiduciary duty.

Dirks has also somehow clarified the notion of constructive insiders, as opposed to mere tippees. These are subjects external to the issuer, who however become fiduciaries of the issuer (and its shareholders) by reason of their professional relation with the issuer. Among constructive insiders, the Court listed underwriters, accountants, lawyers and consultants working for the corporation.[45]

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regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

[42] 463 U.S. 646 (1983). Dirks (tippee), a securities analysts, was contacted by a former officer of Equity Funding of America, who told him of massive fraud in the company. *Id.* at 648. After independent investigation, Dirks concluded that there was fraud resulting in the company overstating its assets. *Id.* at 649. He notified investors causing many of them to withdraw their holdings in the company. *Id.* He owned no stock in the company, and owed no fiduciary duty to its shareholders. *Id*. at 665.

[43] *Id*. at 653.

[44] *Id.* at 661-62.

[45] *Id.* at 655 n. 14.

2.3. The Misappropriation Theory of Insider Trading

Both *Chiarella* and *Dirks* did not, however, resolve a more general issue, only partially addressed by rule 14e-3 with respect to the tender offer setting: what happens to defendants that trade on the basis of inside information not obtained from an issuer or the insider of an issuer, but somehow illegally obtained or used?

The response to this concern is the so-called misappropriation theory advocated by the S.E.C. to regain the ground lost after *Chiarella* and *Dirks*. The theory is simple to state, but raises several interpretative issues. It posits that whenever a fiduciary uses information belonging to his principal for personal gain, without disclosing the use, he commits fraud in connection with the purchase or sale of a security and is liable under Rule 10b-5.[46] The Supreme Court endorsed this theory in *U.S. v. O'Hagan* in 1997.[47] The facts of the case neatly illustrate the point. Grand Metropolitan PLC was contemplating a tender offer on the common stock of Pillsbury Company, and it retained the law firm of Dorsey & Whitney for representation in the planned acquisition.[48] One of the partners of the law firm, O'Hagan, not involved in the representation, came to know of the pending tender offer and, undisclosed to the law firm, purchased shares of the target corporation.[49] When the tender offer was announced, the price of Pillsbury stock rose and O'Hagan pocketed a profit of over four million dollars.[50] The district court sentenced O'Hagan to a prison term for violating Rules 10b-5 and 14e-3.[51] On appeal, the Eight Circuit however reversed the judgment holding that the alleged violation of Rule 10b-5 could not be based on the misappropriation theory, and that Rule 14e-3 was invalid because it did not contain a breach of fiduciary duty requirement.[52]

Justice Ginsburg, writing for the majority of the Court, affirmed two important principles. On the one hand, it affirmed the legitimacy of Rule 14e-3.[53] More relevant to the point at issue here, however, the court also made the misappropriation theory the law of the land.[54] The Court, in fact, held that:

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[46] This theory was somehow prophetically anticipated by Chief Justice Burger in his dissent in *Chiarella*, in which he argued that he would have upheld the conviction because the employee of the printer misappropriated confidential information of his principal. 445 U.S. at 251 (Burger dissenting).

[47] 521 U.S. 642 (1997).

[48] *Id*. at 647.

[49] *Id.*

[50] *Id.* at 648.

[51] *Id.* at 649.

[52] U.S. v. O'Hagan, 92 F.3d 612, 627 (8th Cir. 1996).

[53] 521 U.S. at 676.

[54] *Id.* at 665.

> «In this case, the indictment alleged that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock. […] This conduct, the Government charged, constituted a fraudulent device in connection with the purchase and sale of securities. We agree with the Government that misappropriation, as just defined, satisfies § 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," […] "dupes" or defrauds the principal».[55]

One interesting question that *O'Hagan* raised is whether, under the misappropriation theory, Chiarella would have been held liable. The answer is probably affirmative, because Chiarella could be considered having a fiduciary relationship with his employer, Pandrick Press.[56] The problem with *O'Hagan* and the misappropriation theory more generally, however, is once again that it ties illegal insider trading with a violation of a fiduciary duty. The existence and scope of fiduciary duties is often a murky subject, and therefore immediately after the *O'Hagan* decision in 1997 it became apparent that further guidance was needed to define relevant relationships that might determine insider trading liability.

Consider, for example, the hypothetical of the C.E.O. of a corporation that discloses to her spouse inside information. If the spouse trades on the basis of this information, is he liable? One possibility might be to argue that, under *Dirks*, he is a tippee, but in this case a violation would occur only if the plaintiff can prove that the tipper breached a fiduciary duty, and that the tippee knew or had reason to know about the violation, which might not be the case. The second option, under the misappropriation theory, would be to hold the husband liable because he misappropriated the information of a fiduciary. The delicate question on the table, however, would be if a family relationship creates a fiduciary duty.

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[55] *Id.* at 653 s.

[56] This is also the opinion of MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 370 (5th 2009). It should be noted, however, that in *Chiarella* the Supreme Court did not deal with the misappropriation theory of insider because that theory had not been included in the jury instructions: *see* LOSS, SELIGMAN, PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 1332 vol. 2 (2011). But *see supra*, note 46, on Chief Justice Burger's dissent in *Chiarella*.

This is exactly the question that the Second Circuit faced in *U.S. v. Chestman*[57]. In this case, the Court held that «a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information», and – somehow ironically – that «marriage does not, without more, create a fiduciary relationship».[58] Once again, the choice made by U.S. jurisprudence to base insider trading on the violation of a fiduciary duty poses complex interpretative conundrums and leads to potentially absurd results, because the very notion of fiduciary duties is enveloped in the mists of the common law. We can, for example, surely recognize a fiduciary relationship between «attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate officer and shareholder»[59], but outside of these typical relationships the question whether the misappropriation theory applies can be a difficult one.

Once again, in the aftermath of *Chestman* the S.E.C. felt the need to intervene through its rule-making power to dissipate part of the mist and reduce uncertainty, and to ensure a sufficiently broad reach of insider trading rules. The Commission, in fact, adopted Rule 10b5-2 in order to clarify which relationships might be considered to determine if the fiduciary misappropriated the information belonging to his source. According to this provision, application of the misappropriation theory is triggered when the recipient of the information trades or tips when: (a) he explicitly agreed to maintain the confidentiality of the information; (b) he had a history, practice or pattern of sharing confidences with the source of the information; (c) he is a spouse, child, parent or sibling of the source of the information (subject to an affirmative defense that there was no reasonable expectation of confidentiality). While this rule seems to shed some light on the scope of application of the misappropriation theory, at the practical level it does not always provide clear guidance. For example, what about confidential information given to a physician, bound to keep confidential health issues, but not necessarily other types of information? More generally, it can be observed that:

> «the misappropriation theory does not encompass all forms of outsider trading advantage. Any original "source" of information, for example, may trade freely on that information. Any outsider trader that obtains the information without breaching a fiduciary duty may trade on the information. Even an outsider trader that does breach her fiduciary duty to the source in obtaining

[57] 947 F.2d 551 (2d Cir. 1991).
[58] *Id.* at 567-68
[59] *Id.* at 947, *see supra*, Bainbridge note 19, at 16.

information may avoid misappropriation liability simply by disclosing the theft to the source prior to engaging in trades.»[60]

Things might be changing, however. A recent interesting case decided by the Second Circuit (SEC v. Dorozhko, 574 F.3d 42 (2009)) held that an hacker that obtained inside information by violating a computer and traded on the basis of the information might have committed insider trading even in the absence of a specific violation of a fiduciary duty. The facts are quite interesting: in October 2007 Oleksandr Dorozhko, an Ukrainian national, opened a trading account. On October 17 IMS Health Inc. was expected to announce its earnings reports after the closing of the markets. Starting in the early morning of the same day a hacker attacked repeatedly the computer of the investor relator, Thompson, and at 2:15 pm managed to download the still undisclosed financial information, from which it resulted that the earnings per share of IMS were significantly below market's consent. A few minutes before 3 pm Dorozhko purchased put options on IMS's stock. At 5 pm the negative information was released to the market and, when the stock exchange opened the following day, the market price of the shares dropped almost 30%. Dorozhko, a few minutes after the market opened, sold all its options making a profit of over $280,000. The SEC argued that the defendant violated Section 10b and Rule 10b-5 not because he breached a fiduciary duty, but because he fraudulently accessed inside information (hacking a computer, in this respect, is considered equivalent to misrepresent your identity). The Court of Appeals seemed to agree with the Commission, remanding the case in order to determine if the conduct of Mr. Dorozhko could be considered a «deceptive device or contrivance».

This case is important because it seems to expand the notion of misappropriation, or at least of deceptive device, beyond breaches of a fiduciary duty.

2.4. Other Elements of the Violation: Materiality and Scienter

We have so far focused on the most complex and distinctive feature of insider trading violations under U.S. law, the breach of a duty by the alleged perpetrator. Other elements of the cause of action are, however, also important and raise possible uncertainties. The first one is that the information should be "material." The concept of materiality has been expressed in somehow different ways, and in particular two definitions are used: the information must be «substantially likely to be important to the reasonable investor in making an investment decision», or «substantially likely, in the eyes of the reasonable

[60] Ian Ayres – Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 348 (2002).

investor, to significantly alter the total mix of information available in the market».[61] This standard is a mixed question of law and fact clearly difficult to apply, as it requires an inquiry in the mind of the hypothetical "reasonable investor". In addition, it contains no reference to the possible effect of the information on market prices: even if it seems proper to assume that price-sensitive information should be considered relevant by investors, it is not crystal-clear whether non-price-sensitive information could still be deemed material. Another question not entirely settled is if the inside information, in order to be relevant, must be "precise" enough to allow an inference on the direction in which the market price might move once it is disclosed. This question, which is intertwined with the issue of possession and use of information (*see* below, paragraph 5), can be very relevant: for example, information concerning possible mergers can have different and often not easy-to-predict effects on market prices.[62]

The required state of mind of the defendant is another thorny issue. While generally violations of Section 10(b) require scienter, it is not univocally defined what scienter is. It is clear that it is something more than mere negligence, but is it necessary willfulness or intentionality, or is it sufficient recklessness, or even gross negligence? The SEC has adopted an awareness standard, according to which insiders are liable if they are aware that their conduct would be important in investors' decision to trade, and that they are relying on non-public, material information.[63] This standard is also often very murky to apply.

2.5. "Possession" or "Use" of Inside Information?

Connected with the issue of scienter, or more generally with the required state of mind of an alleged violator of insider trading rules in the U.S., is another one of the most delicate aspects of insider trading in the United States. The question is whether the prohibition should only concern persons that "use" inside information to trade, or also those that merely "possess" inside information when trading. The distinction can be illustrated with an example: if I sell shares while possessing information about a likely increase in their market price, I can be found to have traded while *in possession* of private information, but it should not

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[61] Joan Heminway, *Martha Stewart and the Forbidden Fruit*, 2009 MICH. ST. L. REV. 1017, 1033 (2009).

[62] For a brief discussion on how this question has been addressed under European law, *see* below, Part II, paragraph 1.

[63] 17 C.F.R. § 240.10b5-1 (2010); for a discussion of scienter *see* Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 13 (2006); DONALD C. LANGEVOORT, REFLECTION ON SCIENTER, IN MARTHA STEWART'S LEGAL TROUBLES 234 (Joan McLeod Heminway ed., 2007).

be difficult for me to argue that I have not *used* the information. Clearly enough, the difference is of paramount importance in delimiting the scope of the prohibition. If the S.E.C., the Department of Justice, or private plaintiffs must demonstrate the actual use of inside information, the position of possible defendants is much stronger.

In *United States v. Teicher*, a 1993 case, the Second Circuit adopted the "possession theory", arguing that material information does not "lie idle in the human brain".[64] The possession theory, however, not only stretches the scope of application of the prohibition also to situations that do not seem to fit in its rationale, but might also be considered inconsistent with the scienter requirement of section 10(b). Other courts of appeal, in fact, have held that a proof of use of inside information is necessary[65], and the Supreme Court has indicated that mere possession of confidential inside information is insufficient to impose the disclose or abstain rule.[66]

The split was partially resolved in 2000 by the S.E.C. with the adoption of Rule 10b5-1.[67] This provision states that a person is liable when trades while "aware" of inside information. More precisely, Rule 10b5-1 presumes that someone who trades in possession of inside information has in fact used the information.[68] The rule, however, also contains some affirmative defenses that basically exclude liability if the insider purchases or sells on the basis of pre-

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[64] 987 F.2d 112, 120 (2nd Cir. 1993). *See* Jesse M. Fried, *Insider Abstention*, 113 YALE L. J. 455 (2003), advocating that knowingly possessing inside information should be sufficient to sanction insider trading.

[65] *See* in particular the Eleventh Circuit decision SEC v. Adler, 137 F.3d 1352 (11th Cir. 1998) and the Ninth Circuit decision United States v. Smith, 155 F.3d 1051 (9th Cir. 1998). For a detailed discussion of both cases *see* generally Bryan C. Smith, Comment, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371, 373-75 (1999) (stating the actual use test is a "more strict standard of proof for plaintiffs and prosecutors" compared to the "broader enforcement scheme ... promoted by the SEC" under the possession standard).

[66] Dirks v. SEC, 463 U.S. 646 (1983).

[67] 17 C.F.R. § 240.10b5-1 (2011). The SEC adopted the "knowing possession" or "awareness" standard because it believed that standard more effectively protects investor confidence in market integrity than does the "use" standard; it "reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information." Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, pt. III.A.2 (Aug. 15, 2000), available at http://www.sec.gov/rules/final/33-7881.htm (last visited Dec. 3, 2013); *see* also Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 189 (2003) (noting that "although the possession versus use issue was far from resolved, by 1999 the federal circuit courts were heading down a path that the SEC viewed as undesirable").

[68] THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 496 (6th ed. 2009).

existing plans, contracts or instructions that ensure that the transaction was not based on the knowledge of material nonpublic information.[69]

2.6. Some Preliminary Conclusions: The Regulation of Insider Trading in the U.S. Is Not Only Overly Complex, But Also Inconsistent With Rule 10b-5 Jurisprudence

As it should be clear from the preceding analysis, U.S. courts, and the Supreme Court in particular, found an ingenious way to define and limit insider trading, applying the disclose or abstain rule at the core of insider trading only when a breach of a fiduciary duty owed to the investors on the other side of the transaction, or to the source of information, can be demonstrated.

To sum up the approach followed in the U.S., there are basically three general grounds to establish insider trading liability: (1) the classical theory for primary and constructive insiders, (2) the classical theory for tippees, and (3) the misappropriation theory. First, corporate insiders can be liable for trading on the basis of material private information in violation of a fiduciary duty to the corporation and its shareholders (with which they trade). In addition to “traditional” insiders, such as corporate directors and executives, there are constructive insiders such as underwriters or attorneys that are have a fiduciary relationship with the issuer. Secondly, tippees can be liable for trading, but only if the tipper violated a fiduciary duty in disclosing the information for a personal gain, and the tippee is aware of the violation. Finally, under the misappropriation theory, liability can occur when trading on the basis of information used in violation of a duty of trust and confidence owned to the source of the information. The SEC, with Rule 10b5-2, has identified some of the relevant relationships, including situations in which there is a expressed agreement to maintain the information confidential, when between the source and the person using the information there is a history of sharing confidences, and in case of certain family ties. The recent *SEC v. Dorozhko* decision seems to broaden this notion further, to include information obtained and used misstating your identity, such as in the case of a computer hacker. One additional *ad hoc* prohibition is set forth in Rule 14e-3, and is independent from a violation of a fiduciary duty: the Rule covers tipping and trading in connection with a tender offer. The notion of breach of fiduciary duties as a basis for most insider trading violations created a fragmented, complex, uncertain, and potentially irrational regulatory system, and made enforcement more difficult. It should be pointed out, however, that when the

[69] Steinberg *supra* note 56, at 375.

different theories are considered together, most relevant cases of insider trading are covered.

In addition, other elements of the violation, such as the issues of materiality, scienter, and the question of use of the inside information add further uncertainties and burdens to both private and public enforcement actions.

But there is more. A core problem is that the very use of (a breach of) fiduciary duties as a precondition for insider liability, causes a contradiction within the Supreme Court's very jurisprudence on rule 10b-5.

The reference is to a leading case concerning fraud in connection with the sale of securities: *Santa Fe Industries, Inc. v. Green*[70]. To fully understand this question, a brief discussion of the case is necessary. Santa Fe had acquired 95% of the shares of Kirby, a Delaware corporation.[71] Under Delaware law, a shareholder owning 95% of the shares can effectuate a "short-form merger" which does not require approval of the minority shareholders of the target corporation, cashing out the minorities.[72] The acquiring corporation, however, must notify the minority shareholders indicating the price that it is willing to pay for the shares, and any dissatisfied shareholder can petition the Delaware Court of Chancery to obtain an independent appraisal of their shares.[73] Minority shareholders of Kirby decided not to seek the appraisal remedy, and instead sued Santa Fe arguing that the price proposed grossly underestimated the value of the shares of Kirby.[74] This underestimation, according to the plaintiffs, amounted to a fraud under Rule 10b-5.[75] As correctly pointed out by Bainbridge, the Supreme Court did not accept the theory of the shareholders, essentially holding that «Rule 10b-5 is concerned with disclosure and fraud, not with fiduciary duties».[76] According to the Court in *Santa Fe*, Rule 10b-5 does not cover situations in which the complaint is a violation of a fiduciary duty[77]: this is a corporate law issue governed by state law. It is clear that this holding is at odds with a theory of insider trading based on the violation of a fiduciary duty. If it is true that Section 10b-5 does not cover these violations in the context of a merger, it should follow that they should be irrelevant also for insider trading purposes.

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[70] 430 U.S. 462 (1977).
[71] *Id.* 465.
[72] *Id.*
[73] *Id.*
[74] *Id.* at 466-67.
[75] *Id.* at 467.
[76] Bainbridge note 19, at 13.
[77] 430 U.S. at 479.

A fiduciary-duty based theory of insider trading, therefore, not only creates complexities in the applicable regime, but also determines a conflict within the jurisprudence of the Supreme Court on rule 10b-5.

2.7. Absence of a General Duty to Disclose Material, Nonpublic Information and Selective Disclosure

Corporations registered under the Exchange Act have a "continuous disclosure" obligation. While disclosure duties are broad, and require an issuer to update previously disclosed information, the Exchange Act does not provide for a general duty to disclose *all* material information.[78] This feature of the American system can be pointed out as a major comparative difference with the current European approach. While this observation is well-grounded, it requires some qualifications.

First, it should be pointed out that periodic reports that must be published pursuant to Section 13 of the Exchange Act are quite extensive; additionally, corporations have a duty to update the information published, in particular with respect to material changes in the financial condition or operation of the issuer.[79] Clearly enough, this "duty to update", form a practical point of view, leads to extensive continuous disclosure obligations, because often an inside, price-sensitive information triggers the duty. Additionally, in the last ten years, the SEC has also expanded the items that need to be disclosed promptly on Form 8-K, and there is a trend to further increase occasional disclosure obligations.[80] It is true, however, that absent a duty to update previously released information registered corporations do not have an affirmative obligation to disclose *all* material information until the next quarterly report is due.[81] Of course, if the corporation is dealing in its own securities on the basis of inside information, Section 10(b) imposes a disclose or abstain duty, but absent trading activities there are many situations in which the corporation can remain silent on material developments.

It should be noted, however, that stock exchanges generally require listed corporations to promptly disclose to the public information material to a reasonable investor.[82] These rules are not, however, strongly enforced: according to a leading treatise, stock exchanges have rarely imposed sanctions for the

[78] Karmel note 13, at 114.
[79] *See* Sarbanes-Oxley Act of 2002, Pub. Law 107-204, § 409 (July 30, 2002).
[80] Hazen note 68, at 551.
[81] *Id.*
[82] N.Y.S.E. Company Manual, Fed.Sec.L.Rep. (CCH) ¶ 23,121 (1977); American Stock Exchange Company Guide (CCH) ¶ 10,121; Sec.Exch.Act Rel. No. 34-8995 (oct. 15, 1970).

violations of these rules, and the SEC lacks the power to prosecute the violation of listing requirements.[83]

An affirmative duty to speak also cannot be established based on directors' and officers' fiduciary duties, and issuers are generally allowed to respond to market rumors with a simple "no comment".[84]

If no general affirmative obligation to disclose all material information exists under U.S. law, since 2000 Regulation FD prohibits most selective disclosures to only some third parties.[85] The rules adopted by the SEC built on previous stock exchange rules against selective disclosure to analysts.[86] Pursuant to Regulation FD, communications by the company's senior management and investor relations professionals made to analysts must be promptly disclosed to the public; the provision does not apply to communications to the press (that are supposed to reach the public in any case), to rating agencies and to communications in the ordinary course of business with business partners.

Regulation FD is relevant to our comparative analysis because it is a clear application of the equal access to information approach. In this respect its underlying rationale should be distinguished from the fiduciary-based theory of insider trading.

2.8. Section 16(b) of the Exchange Act

Any discussion of insider trading regulation in the U.S. is incomplete without reference to Section 16(b) of the Exchange Act, the so-called prohibition against short-swing profits by insiders. This is, in fact, the original and only provision contained in the 1934 legislation explicitly addressing insider trading. Differently from Rule 10b-5, Section 16(b) is a prophylactic and crude rule of thumb that targets specific transactions by only three categories of insiders: directors, officers and 10% shareholders that purchase and sell, or sell and

[83] Hazen note 68, at 511.
[84] Hazen note 68, at 555; *see* e.g. *Little Can be done to Stop Rumors, Exchange Officials, Others Tell Forum*, 18 SEC. REG. & L REP. (BNA) 253 (Feb. 25, 1986) observing that while the "no comment" response may be necessary for business reasons, as issuers develop increasing "no comment" policies, less information will be filtered into the market; Thomas Lee Hazen, *Rumor Control and Disclosure of Merger Negotiations or Other Control-Related Transactions: Full Disclosure or "No Comment"--The Only Safe Harbors*, 46 MD. L. REV. 954, 955 (1987) discussing the benefits of a no comment policy; James Koenig, *The Basics of Disclosure: The Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1074 (1989) arguing that "when a corporate manager uses a "no comment" policy to avoid being under a duty to disclose, public statements will not be required, material information can be concealed, and investor access to information will be reduced".
[85] 17 C.F.R. §§ 243.100-243.103.
[86] N.Y.S.E. Company Manual ¶ 202.02(A).

purchase, equity securities of an issuer within six months.[87] Any profit that these insiders make must be disgorged to the issuer.[88]

The provision is only apparently simple and straightforward. In fact it rises numerous and complex interpretative questions that have been the object of extensive scholarly work and great attention by practitioners.[89] It would be beside the point, in this Article, to provide a detailed analysis of this rule. A cursory overview of its structure and of the main issues it raises should be sufficient to offer a general picture of the different regulatory weapons used to contrast insider trading in the United States.

The first pillar of Section 16 is a reporting requirement for directors, officers, and beneficial owners of more than ten percent of a class of voting registered security. These persons are presumed to be potential insiders, likely to have access to private information.[90] The definition of these categories has raised interpretative questions: for example it is not always easy to clearly identify "officers". The general rule is that an officer performs significant policy-making functions, and substance should prevail over the mere attribution of a title such as "vice-president". It is intuitive, however, that this definition sometimes requires a complex factual analysis on the actual powers of the alleged officer.

In any case, directors, officers, and relevant shareholders must disclose their ownership interests to the SEC and to the public within ten days of their appointment or acquisition of the shares. In addition, any change in their shares ownership must also be communicated within – pursuant to the Sarbanes-Oxley Act – two days of the change.

The core of the rule is Section 16(b), which mandates disgorgement of all profits made buying and selling, or selling and buying equity securities within a six months period ("short-swing profits). The idea, clearly enough, is that profits so realized are likely to be based on the use of inside information: as mentioned, this is a somehow crude absolute presumption that has a prophylactic function.

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[87] 15 U.S. Code § 78p.

[88] 15 U.S. Code § 78p(b) stating that the profits "shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer."

[89] See generally Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183 (1992); Arnold S. Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934*, 32 N.Y.L. SCH. L. REV. 209 (1987); Steve Thel, *The Genius Of Section 16: Regulating The Management Of Publicly Held Companies*, 42 HASTINGS L.J. 391, 481 (1991).

[90] American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1055 (2d Cir. 1975) ("The 10% holder in the garden variety case is presumed to be 'influential' as a friend of management or in control of some directors.").

One of the more complex and delicate issues under Section 16(b) is the computation of profits. In short, notwithstanding some conflicting precedents,[91] in case of multiple sales, the most commonly applied rule is to match the lowest purchase price against the highest sale price in the relevant period.[92] The consequence is that the liability can exceed the actual profits realized, and in fact disgorgement of "profits" can even occur when the insider lost money in the transactions.[93] This approach has raised criticism, because it evokes a measure of punitive damages in excess of actual damages, contrary to Section 28(a) of the Exchange Act.[94]

3. The European approach to insider trading: parity of information

3.1. European Regulation of Insider Trading: The Market Abuse Directive of 2003

In Europe, a crucial concern behind the regulation of insider trading is market egalitarianism.[95] As it has been observed, «[i]f investor confidence and the efficient operation of the market are the dominant objectives, the source of the inside information is largely irrelevant, although it is central if the prohibition is based on fiduciary concepts».[96] This statement nicely captures the key difference between regulation of insider trading in the US and in Europe.

The core concept of the Market Abuse Directive of 2003 ("MAD") is the definition of "inside information".[97] This is information of a precise nature that

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[91] Feder v. Frost, 1999 WL 163174, 31 Sec. Reg. & L. Rep. (BNA) 465 (S.D.N.Y. 1999).

[92] Arrow Distributing Corp. v. Baumgartner, 783 F.2d 1274, 1277-78 (5th Circ. 1986); Whittaker v. Whittaker Corp.; 63 F.2d 516, 530-32 (9th Circ. 1981), *cert denied* 454 U.D. 1031; Gratz v. Claughton, 187 F.2d 46 (2nd Circ. 1951); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Circ. 1941), *cert denied* 321 U.S. 751 (1943).

[93] Numerical examples are offered by ARTHUR PINTO AND DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 478 (2013).

[94] *See* Hazen note 68, at 539.

[95] NIAMH MOLONEY, EC SECURITIES REGULATION 925 (2nd 2008). The reasoning for prohibiting insider dealing is only briefly mentioned in the Market Abuse Directive. Recital 12 states that the prohibition ensures the integrity of Community financial markets and enhances investor confidence in those markets and Recital 15 adds that insider dealing "prevents full and proper market transparency, which is a prerequisite for trading for all economic actors in integrated financial markets". Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), [2003] OJ L 96/16. *See* also Mathias Siems, *The EU Market Abuse Directive: A Case-Based Analysis*, 2 L. & Fin. Markts. R. 39 (2008).

[96] Moloney note 95, at 928.

[97] Market Abuse Directive Arts. 2-4 with Art. 1(1). See also Directive 2004/124/EC, art 1 and CESR/06-562, Part 1. Art. 1(1) of MAD refers to "information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments, and which, if it were made public, would be likely to have a

has not been made public relating, directly or indirectly, to one or more issuers or one or more securities.[98] The characterization of inside information as precise is necessary to exclude opinions or rumors from the definition.[99] More specifically, according to the directive, information is precise if it indicates a set of circumstances which exists or may reasonably be expected to come into existence, or an event that has occurred or may reasonably be expected to occur and is specific enough to allow a conclusion on the possible effects on the prices of the securities.[100] The information has also to be price sensitive in the sense that, if made public, it would likely have a significant effect on the price of the securities.[101] Similarly to the U.S., information is deemed price-sensitive under Article 1(2) of the directive if a reasonable investor would be likely to use it as a basis for her investment decisions.[102]

The definition of information relevant for insider trading purposes, and also for disclosure obligations (as we will see below, in paragraph 3, under EU law inside information must be disclosed to the market unless there is a valid reason to delay disclosure), has been addressed in several cases decided by the European Court of Justice. One of the most relevant ones is *Geltl v. Daimler AG*, which raised the issue of when information concerning a possible future event becomes relevant for insider trading and should be disclosed.[103] The case reminds of *Basic v. Levinson*, the U.S. Supreme Court decision that hold that information concerning possible future events becomes material when, based on a "probability-magnitude" test, it appears to be relevant for investors. The U.S. Supreme Court, in other words, in this respect held that the likelihood of a future event (e.g. a merger, the launch of a tender offer, a court's decision, etc.) should be factored in with its possible effects on market priced to decide if an information is material. Under this approach, also a relatively unlikely event, which however could have a profound impact on the market, should be disclosed.

Geltl dealt with the resignation of the CEO of DaimlerChrysler AG, Mr. Schrempp, in 2005. To make a long story short, the decision to resign, and the

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significant effect on the price of those financial instruments or on the price of related derivative financial instruments".

[98] See examples in CESR/06-562, paras 1.15, 1.16.

[99] Rumors represent general talks of doubtful accuracy, and are therefore not covered. See Moloney note 95, at 753.

[100] *Id.* The word "specific" was added to clarify that information which is exact on one matter (e.g. that there will be a dividend increase) need not cover all aspects of the same (e.g. the amount of the increase). *See* BARRY ALEXANDER K. RIDER & T MICHAEL ASHE, INSIDER CRIME: THE NEW LAW 32 (1993).

[101] See CESR's Advice on Level 2 Implementing Measures for the proposed Market Abuse Directive 9 (Dec. 2002), *see* aslo Siems note 95, at 41.

[102] See Basic Inc. v. Levinson, 485 U.S. 224, 231-232 (1988), and STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS 594 (2002).

[103] ECJ Case C-19/11 *Geltl v Daimler*, 28 June 2012.

related resolutions of the corporation, developed over a period of several weeks. The information was however disclosed to the market only when the board of supervisors formally approved the resignation and appointed a new CEO, on July 28, 2005. The price of the shares increased after the announcement, and Mr. Geltl, a shareholder who had sold the shares before it, sued claiming that the information should have been disclosed before the formal decision of the board of supervisors. The *BaFin*, the German regulator, also imposed sanctions. The issue reached the German Federal Supreme Court, the *Bundesgerichtshof*, which raised two certified questions for the European Court of Justice. The first was whether the "intermediate steps" that lead to a future specific event could be considered precise information for the purposes of the MAD directive; the second was whether in considering the relevance of an information, its likelihood could be combined with its potential effect on the market; in other words, if a "probability-magnitude" test could or should be applied. The European Court answered the first question in the affirmative, but rejected the use of a "probability-magnitude" test (contrary to the opinion of the Advocate General), holding that in order to decide if an information concerning a future event must be disclosed it is necessary to consider if there is a realistic prospect that the event will occur. In fact the Court has not clarified the degree of likelihood that is relevant, but the key point here is the rejection of the U.S.-style probability-magnitude test.[104]

Another question that was raised recently on the definition of inside information for MAD purposes is if inside information can be considered relevant for both disclosure purposes and insider trading prohibitions only if it allows an unambiguous conclusion on how the market price will react to the disclosure, *i.e.* if it will go up or down.

The issue is the object of another certified question submitted to the European Court of Justice in December 2013, this time by the French *Cour de cassation*, and not yet decided at the time of this writing. The case is *Lafonta v. AMF*, and it deals with swaps agreements concerning the shares of the Saint-Gobain corporation by Wendel, an investment company listed on the EuroNext Stock Exchange. The core question was not profoundly dissimilar to the one addressed in the *Grande Stevens* case (below, paragraph 5). The French controlling authority claimed that Wendel and its CEO, Mr. Lafonta, did not properly disclose their acquisition of a stake in Saint-Gobain through the use of derivative instruments; the defense to this accusation was that the effect on the market prices of this information is not clear, and therefore the information is not

[104] For further discussion of *Geltl* see Hartmut Krause – Michael Brellochs, *Insider Trading and the Disclosure of Inside Information after* Geltl v. Daimler *– A Comparative Analysis of the ECJ Decision in the* Geltl v Daimler *case with a view to the future of European Market Abuse Regulation*, in 8 Capital Markets L. J. 283 (2013).

precise in the sense of Article 1(1) of Directive 2003/124/EC, and there could not be a use of inside information. The first commentators seem to agree with this conclusion, which frankly appears perfectly in line with the text and purposes of the directive, but it remains to be seen what the European Court of Justice will decide.[105]

We dedicated some space to the notion of inside information under EU law, in the light of its statutory definition and its central role in the application of the relevant rules. For the purposes of our comparison with U.S. law, however, we should now focus on the fact that the Directive contains broad provisions (in Articles 2 and 3) that prohibit persons in possession of inside information from: (a) dealing in the securities to which the information relates using inside information;[106] (b) disclosing inside information to third parties unless the disclosure is made in the normal course of employment, profession or duties;[107] (c) recommending or inducing other persons, on the basis of inside information, to trade.[108]

One important difference with the U.S. approach emerges considering the persons subject to the prohibition. They can be divided in primary and constructive insiders, defined in Article 2 of the Directive, and other persons, defined in Article 4. The formers are persons who possess the information by virtue of (a) their membership in the administrative, management or supervisory bodies of the issuer; (b) their holding in the capital of the issuer; (c) their employment, profession or duties; (d) criminal activities.[109] It is interesting to compare this list with the list of possible insiders under U.S. law. Persons indicated from (a) through (c) would, in all likelihood, be considered primary or constructive insiders also under U.S. law under rule 10b-5. Their inclusion in the scope of the prohibition, however, would be based on the existence of a fiduciary relationship with the issuer, shareholders, or the source of information. It is however questionable if, under U.S. law, persons possessing inside information by virtue of criminal activities would be considered insiders if they did not breach a specific fiduciary duty, even if obviously they might be sanctioned through the application of other rules. The above mentioned *Dorozhko* case suggests that they would be.

The key difference between the two approaches emerges, however, when we consider Article 4 of the MAD. Under this provision, the prohibitions set

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[105] See Lars Klöhn, *Inside Information without an Incentive to Trade? What's at Stake in "Lafonta v. AMF"*, April 2014, available on *www.ssrn.com*.
[106] Market Abuse Directive Art. 2(1).
[107] *Id.*
[108] Market Abuse Directive Art. 3.
[109] Market Abuse Directive Art. 2(2)(a), (c).

forth by Articles 2 and 3 also extend to anyone «who possesses inside information while that person knows, or ought to have known, that it is inside information».[110]

This provision clearly demonstrates that the European prohibition of insider trading is based on an equal access to information theory, and not on fiduciary duties.[111] Consider the following example based on the facts of *Texas Gulf Sulphur*. Imagine that an agent of the corporation meets a farmer owning land that the corporation wishes to buy because of the nonpublic discovery of the ore deposit. If the agent shares the inside information with the farmer, without any specific confidentiality obligation, and the farmer buys the securities at a low price and sells them at a higher one once the information becomes public, he would probably not be guilty of insider trading under U.S. law. More precisely, he could be liable under *Dirks* but only if it could be proven that the insider breached a fiduciary duty for his personal gain, and that the tippee knew or should have known about the breach. On the contrary, in Europe the farmer would have violated the prohibition against insider trading: the only element that needs to be proved is that he ought to know of the inside nature of the information received by the corporation's agent.

It should be noted that, under European law, the tippee does not need to have received the information from an insider that has breached a fiduciary duty.[112] Even if the inside information is revealed to a third party through a long chain of tippees-tippers, the person trading might be liable as long as she trades on the basis of inside information being aware of the inside nature of the information.

A second difference with U.S. regulation concerns the question of use versus simple possession of the information. In interpreting and implementing European law, most national legislatures and regulators seem to consider necessary, in order to commit market abuse, to trade *using* the inside information. This is, for example, the case with U.K. law: Section 118(2) of the Financial Services and Markets Act requires insiders to deal «on the basis» of inside information; not differently, under German law, § 14(1) of the *Wertpapierhandelsgesetz* indicates that the insider must "use" the information;

[110] Market Abuse Directive Art. 4. This provision defines the scope of secondary or constructive insiders, which are similar to that of a tippee under US law. *See* Bainbridge *supra* note 102, at 564, citing Dirks v. SEC, 464 U.S. 646 (1983).

[111] Under the Directive, the primary insiders are identified on the basis of their access to inside information due to their position, and constructive insiders are identified for possessing information that they know ought to know is inside information. See Cady, Roberts and Co., 40 SEC 907 (1961). See Reinier H. Kraakman, "The Legal Theory of Insider Trading Regulation in the United States", in Hopt and Wymeersch (Eds.) European Insider Dealing 41 (1991) at pages 46-7 for a comparison of US law with the former Insider Dealing Directive.

[112] *See* Guido Ferrarini, *The European Market Abuse Directive*, 41 COMMON MARKET L. R. 711, 723 (2004).

again, Article 184 of the Italian *Testo Unico della Finanza* prohibits trading using ("*utilizzando*") inside information. Pursuant to this approach, for example, if the farmer in the previous example sells securities of the corporation because he needs cash, he would not be held liable.

In the case of *Spector Photo Group NV*, however, the European Court of Justice seemed to read the European directive differently and more broadly.[113] The decision involved a Belgian corporation that had purchased own shares in order to carry on an employee stock-option plan, but later announced its financial results and an acquisition plan that affected positively its market prices. One of the questions raised by the Belgian courts was if the MAD directive had to be interpreted as prohibiting trading using, or also only possessing, inside information. The European Court of Justice gave a somehow ambiguous answer, but it seems basically to consider that possession of material inside information implies a presumption of use if the insider deals in securities. The presumption, however, can be rebutted, in particular because the Court held that only use that conflicts with the purposes of the directive of equal access to information is prohibited. It seems, therefore, that for example selling securities when the inside information indicates a likely imminent increase of the market prices should not be prohibited.[114]

This decision is, in any case, interesting and relevant to our comparison because even if the text of the directive and the way in which it has been implemented in several Member states might appear to focus on the "use" of inside information, the European Court of Justice has embraced a somehow broader concept, not too different from the American approach. As discussed above, in fact, in the U.S. it seems to be sufficient that an insider trades while aware of material nonpublic information, also a conclusion that raises some possible criticisms.

3.2. Limitations to the Broad Coverage of Insider Trading in Europe

The scope of the European prohibition against insiders, based on an equal access to information theory, is extremely broad. For this reason, specific exemptions are provided to allow trading in possession of inside information when appropriate.

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[113] ECJ Case C-45/08 *Spector Photo Group NV*.

[114] On this decision *see* Lars Klöhn, *The European Insider Trading Regulation after the ECJ's* Spector Photo Group-*decision*, in 2 EUROPEAN COMPANY AND FINANCIAL L. REV. 347 (2010); Katja Langenbucher, *The 'use or possession' debate revisited – Spector Photo Group and insider trading in Europe*, in 5 CAPITAL MARKETS L. J. 452 (2010).

The best example of this regulatory approach concerns takeovers. In theory, the bidder, before launching a tender offer, possesses inside information concerning the target, including its very decision to launch the public offer. Insider trading prohibitions might, therefore, hinder the market for corporate control. The MAD, therefore, excludes – to some extent – the use of inside information in the context of a public offer or M&As from the scope of application of the directive.[115]

It is interesting to point out this element because it allows to highlight the differences between the U.S. and European regulatory approaches to insider trading. In the U.S., as we have seen, the fact that insider trading is predicated upon the violation of a fiduciary duty, would exclude the bidder or persons knowing about the impending bid from insider trading prohibitions, since – as it was hold in *Chiarella* – they would not be considered fiduciaries of the investors in the target corporation. It was therefore necessary that the S.E.C. specifically regulated insider trading in the context of a tender offer through rule 14e-3 in order to limit market abuses. In Europe, the approach is the opposite: the general prohibition of insider trading, based on parity of information, is very broad and would also extend to the tender offer context. It is therefore necessary to explicitly carve out exemptions in order to allow tender offers.

3.3. The European Duty to Disclose Inside Information and "Fair Disclosure" European Style

Another difference between the European and American regulation of insider trading can be identified in the fact that, as we have discussed, under U.S. law there is no general duty to disclose material, nonpublic information (even if, in the light of the extensive affirmative disclosure obligations, and the duty to correct and update previously published information, the material information that can be withhold from the public are quite limited).[116] The European approach, however, is different, and once again this indicates that its underlying philosophy is equal access to information.

The general rule set forth by Article 6, paragraph 1, of the MAD reads as follows: «Member States shall ensure that issuers of financial instruments inform

[115] *See* "Whereas (29)" of the directive: «Having access to inside information relating to another company and using it in the context of a public takeover bid for the purpose of gaining control of that company or proposing a merger with that company should not in itself be deemed to constitute insider dealing.» On this issue, *see* also NIAMH MALONEHY, EC SECURITIE REGULATION 959 (2nd ed. 2008). Consider, however, the *Spector Photo Group* case, discussed before, which appears to indicate the possible relevance of information concerning a pending acquisition in case of purchase of shares of the bidder/acquirer.
[116] *Supra*, paragraph II.7.

the public as soon as possible of inside information which directly concerns the said issuer». The default rule in Europe, therefore, is that inside information should be promptly disclosed to the market. This is interesting because it suggests that European law does not accept the principle that inside information belongs to the issuer and can be misappropriated by insiders, but rather that it "belongs" to all investors and, as a general matter, should be shared with the investing public.[117]

Of course, there are exceptions. Most importantly, paragraph 2 of Article 6 of the MAD provides that an issuer may delay the public disclosure of inside information in order not to prejudice his legitimate interests, provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information. For example, in the case of a negotiated merger, the issuer can legitimately decide not to disclose inside information concerning the acquisition if the disclosure might adversely affect the outcome of the negotiation. This decision, however, might expose the issuer to liability toward its shareholders or investors if it is considered misleading. Discriminating between information that must be disclosed and that might be delayed is very complex. For reasons that will be discussed below, however, in most European systems it is also fairly difficult for an investor or group of investors to invoke the liability of the issuer for its decision not to disclose.[118]

Paragraph 3 of Article 6 of the MAD contains the European equivalent of U.S. Regulation FD.[119] It provides that whenever an issuer, or a person acting on his behalf or for his account, discloses any inside information to any third party in the normal exercise of his employment, profession, or duties he must make complete and effective public disclosure of that information, simultaneously in the case of an intentional disclosure and promptly in the case of a non-intentional disclosure. Consequently, if an issuer holds a meeting with financial analysts in which inside information is given, the same information should also be shared with the investing public, not dissimilarly from what is provided by Regulation FD in the United States.

In an interesting twist, however, the Directive provides that this duty of public disclosure does not apply if the person receiving the information is bound to a duty of confidentiality.[120] The consequence is that an issuer may, for example, selectively share inside information with its controlling shareholder, as long as the latter must keep the information confidential. Of course the

[117] See supra note 95.
[118] *Infra,* paragraph IV.2.
[119] *Supra* paragraph II.7.
[120] See Ferrarini supra note 107 at 733 giving examples of accountants and lawyers.

controlling shareholder is still subject to the general prohibition against insider trading, and therefore is not allowed to trade using the confidential information.

3.4. Reform of the MAD Directive and MA Regulation

At the time of this writing, the European Union is in the process of modifying the existing legislative framework provided by the MAD, in order to make financial markets more sound and transparent and ensure a higher level of market integrity and investor protection.[121] In particular, a proposal for a Regulation on insider dealing and market manipulation[122] has been adopted as well as a proposal for a Directive on criminal sanctions for market abuse.[123] The latter was recently approved by the European Parliament,[124] while political agreement endorsed by the European Parliament was reached with regard to the Market Abuse Regulation ("MAR").[125]

A detailed discussion of all the possible changes to the current regulation is not necessary for the purposes of this work; suffice it consider the major innovations that have been or are expected to be introduced. As to the MAR, it aims to update and strengthen the existing framework. The MAD, indeed, will be repealed with effect from two years after entry into force of the MAR.[126]

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[121] *See* European Commission Press Release, *Getting tough on insider dealing and market manipulation* (2011), *available at* http://europa.eu/rapid/press-release_IP-11-1217_en.htm?locale=en).

[122] Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM (2011) 651 final of 20 October 2011 (in the following: "Draft Regulation"). The Draft Regulation was subsequently amended. *See* Amended proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM (2012) 421 final of 25 July 2012 (in the following: "Amended Draft Regulation")

[123] Proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation, COM (2011) 654 final of 20 October 2011 (in the following: "Draft Directive"). The Draft Directive was subsequently amended. . *See* Amended proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation, COM (2012) 420 final of 25 July 2012 (in the following: "Amended Draft Directive").

[124] European Commission, *Statement by Vice-President Reding and Commissioner Barnier on European Parliament's vote to approve criminal sanctions for market abuse directive* (4 February 2014), *available at* http://europa.eu/rapid/press-release_MEMO-14-77_en.htm?locale=en. According to Article 10 of the Draft Directive, Member States will have two years to implement the Directive in national law after entry into force.

[125] European Commission, *Statement by Commissioner Michel Barnier on the endorsement by the European Parliament of the political agreement on new European rules for market abuse* (10 September 2013), *available at* http://europa.eu/rapid/press-release_MEMO-13-773_en.htm?locale=en.

[126] Draft Regulation, Article 34.

To keep pace with market developments and avoid regulatory arbitrage among trading venues, the Regulation will extend the scope of existing EU legislation to financial instruments traded on a multilateral trading facility (MTF), or on an organized trading facility (OTF) and to any related financial instruments traded OTC which can have an impact on the covered underlying market. The proposed Regulation also applies to transactions or conducts relating to spot commodity contracts which may have an effect on financial instruments. The manipulation of benchmarks will also be covered[127] as well as emission allowances that will be reclassified as financial instruments as part of the review of the Markets in Financial Instruments Directive.[128]

The definition of market manipulation is extended to include transactions in related spot markets in order to prevent cross-market manipulation.[129] Further, attempts at market manipulation are prohibited, thereby enhancing market integrity.[130] Because of the increase in the use of automated trading methods, specific examples of strategies of market manipulation based on algorithmic and high frequency trading are provided, ensuring consistent supervisory practices among competent authorities.[131]

One of the most important innovations is that, differently from the MAD that adopts the same definition of inside information both for disclosure obligations and prohibition against insider dealing, the proposed Regulation differentiates between the two cases by introducing a broader notion of inside information relevant for insider dealing. Acknowledging that inside information can be abused before an issuer is under the obligation to disclose it,[132] information that a reasonable investor would regard as relevant when taking and investment decision will qualify as inside information for insider trading purposes.[133] This notion may include information relating to the state of contract negotiations, terms provisionally agreed in contract negotiations, the possibility of the placement of

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[127] Amended Draft Regulation, at 5.
[128] Draft Regulation, Article 2. *See* European Commission, Explanatory Memorandum to the Draft Regulation, at 6-8.
[129] Draft Regulation, Article 8. *See* Explanatory Memorandum to the Draft Regulation, at 7.
[130] Draft Regulation, Articles 8(2), 10. *See* Mathias Siems & Matthijs Nelemans, *The Reform of the EU Market Abuse Law: Revolution or Evolution?*, 19 MAASTRICHT J. EUR. COMP. L. 195, 198 (2012) (discussing the need for a clear definition of 'attempt').
[131] Draft Regulation, Article 8(3)(c). *See* Explanatory Memorandum to the Draft Regulation, at 8.
[132] Draft Regulation, Recital 14; Explanatory Memorandum to the Draft Regulation, at 9.
[133] Draft Regulation, Articles 6(1)(e), 12(3). *See* Carmine Di Noia, *Pending issues in the review of the European market abuse rules*, 19 ECMI Policy Brief (2012) 1, 2 *available at https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=2028918* (arguing for a more detailed rule to limit courts' discretion).

financial instruments, conditions under which financial instruments will be marketed, or provisional terms for the placement of financial instruments.[134]

Concerning the public disclosure of inside information, it should be noted that where the information is of systemic importance and it is in the public interest to delay its publication, the draft Regulation introduces the possibility for the supervisory authority to permit such a delay so that the stability of the financial system is preserved.[135]

Another important area addressed by the proposal concerns the powers attributed to national supervisory authorities. As for the powers of investigation, in order to introduce a level playing field in the internal market[136], the Regulation, on the one hand, provides that competent authorities shall have the power to enter private premises to seize documents, subject to prior authorization from the judicial authority of the Member State.[137] On the other hand, it ensures that competent authorities have access to existing telephone and data traffic records held by a telecommunication operator or by an investment firm where necessary to prove insider dealing or market manipulation.[138] In fact, however, several Member States already provide for similar rules.

In light of the fact that market abuse can take place across borders and different markets, the proposed Regulation requires competent authorities to cooperate and exchange information with ESMA and with other competent authorities.[139] To this end, ESMA should play a strong coordination role.[140] Cooperation with third countries' competent authorities is covered as well.[141]

Further, considering the current inconsistency of the sanctioning regimes among Member States and the risk of regulatory arbitrage, the Regulation also addresses the power of competent authorities to impose administrative measures and sanctions.[142] Minimum rules are introduced in this respect.[143] In particular, it is worth noting that administrative pecuniary sanctions could exceed any profit gained or loss avoided, up to twice these amounts: an approach more similar to the U.S. rules, introduced with the 1984 Insider Trading Sanctions Act, which

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[134] Draft Regulation, Recital 14; Explanatory Memorandum to the Draft Regulation, at 9.
[135] Draft Regulation, Article 12(5); Explanatory Memorandum to the Draft Regulation, at 9-10.
[136] Explanatory Memorandum to the Draft Regulation, at 11-12 (acknowledging the need for a level playing field with regard to the powers of investigation).
[137] Draft Regulation, Article 17(2)(3).
[138] Draft Regulation, Article 17(2)(f).
[139] Draft Regulation, Articles 18, 19, 30; Explanatory Memorandum to the Draft Regulation, at 12.
[140] *See* Explanatory Memorandum to the Draft Regulation, at 12.
[141] Draft Regulation, Article 20.
[142] Explanatory Memorandum to the Draft Regulation, at 12-13.
[143] Draft Regulation, Article 26.

allows the SEC to seek penalties up to treble the profits gained through insider trading activities.[144]

The European Commission recognized that the definition of which forms of insider dealing or market manipulation constitute criminal offences diverge considerably among Member States.[145] In addition, current sanctions for market abuse have been not dissuasive enough to ensure effective enforcement of the legislation on market abuse.[146] In this context, the Directive on criminal sanctions provides for minimum rules on criminal offences and criminal sanctions for market abuse. Insider dealing and market manipulation are regarded as criminal offences when committed intentionally.[147] Inciting, aiding and abetting the above-mentioned criminal offences are also punishable as well as the attempt to commit one of these offences.[148] Legal persons should be subject to criminal liability where the market abuse offences have been committed for their benefit by any person who has a leading position within the legal person or where the offences are due to a lack of control by such a person.[149] Finally, Member States are required to ensure that the criminal conducts identified by the Directive are subject to effective, proportionate and dissuasive criminal sanctions.[150]

3.5. The European Court of Human Rights and Market Abuse Regulation. Grande Stevens and others v. Italy

A recent and groundbreaking decision of the European Court of Human Rights (ECHR) in Strasburg might deeply affect the structure of the Italian and European regulation of market abuse (insider trading and market manipulations). The case is *Grande Stevens and others v. Italy*, and was decided on March 4, 2014.[151]

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[144] Pierre-Henri Conac, *Is Europe finally converging with the US on sanctions for insider trading and other market abuses?*, on The CLS Blue Sky Blog (Apr. 2, 2013), available at: http://clsbluesky.law.columbia.edu/2013/04/02/is-europe-finally-converging-with-the-us-on-sanctions-for-insider-trading-and-other-market-abuses/.
[145] European Commission, Explanatory Memorandum to the Draft Directive, at 3.
[146] *Id.*
[147] Draft Directive, Articles 3, 4; Amended Draft Directive, at 4(extending the scope of the criminal offence of market manipulation to include the direct manipulation of benchmarks, if committed intentionally).
[148] Draft Directive, Article 5; Amended Draft Directive, at 4 (criminalizing inciting, aiding and abetting the manipulation of benchmarks as well as attempts at such manipulation).
[149] Draft Directive, Article 7.
[150] Draft Directive, Articles 6, 8.
[151] Cour Européenne des Droit de l'Homme, March 4 2014, nn. 18640/10, 18647/10, 18663/10, 18668/10 e 18698/10, *Grande Stevens et autres c. Italie*; the text of the decision, available in French, is available on the website of the Court at: http://www.echr.coe.int/Pages/home.aspx?p=home. For a first comment, *see* M. Ventoruzzo,

The facts can be briefly summarized as follows. In 2005, the corporations that controlled the car manufacturer Fiat, renegotiated a financial contract (equity swap) with Merrill Lynch. Under the contract, shares of Fiat could be obtained under certain conditions. One of the goals of the agreement was to maintain control over Fiat in the light of the conversion of bonds into shares, without being required to launch a mandatory tender offer. Consob, the Italian Securities and Exchange Commission, initiated an administrative action against the corporation and some of its managers and consultants, claiming that they did not properly disclose the renegotiation of the contract to the market. The procedure resulted in heavy administrative sanctions (for some individuals, up to 5 million euro), and additional measures prohibiting some of the people involved from serving as corporate directors and practicing law. At the same time, a criminal investigation was launched for the same facts. One of the features of the Italian regulation of insider trading and market abuse, in fact, is that the same conducts can be punished both with an administrative sanction and a criminal sanction. This is the case also in other European countries, and the MAD provides that States must regulate administrative sanctions, but can also provide for criminal liability, and as mentioned in the previous Paragraph further regulation of criminal sanctions is provided by the new Directive on this issue. It is not necessary here to discuss the merits of the controversy, it is sufficient to mention that the sanctioned parties challenged the sanctions in Italian courts, but did not prevail.

Hence the lawsuit in Strasburg. Simplifying a very long and complex decision, which is stirring a lively debate, the ECHR, following some of its precedents, confirmed some basic principles concerning the European Convention on Human Rights that, however, can have a revolutionary effect on the regulation of market abuses. The starting point of the reasoning of the European judges is that the sanctions, formally defined as "administrative" in nature under Italian law, are substantially "criminal" sanctions in the light of their harshness and of the possibility to apply measures that affect the ability of the accused to work and their honorability. If the sanctions are criminal in nature, the application of the European Convention of Human Rights follows, and specific protections for the accused must be granted. In this perspective, the ECHR criticizes the sanctioning procedure followed by Consob, arguing that it does not sufficiently guarantee the right of the accused to defend himself, and that there is not a sufficient separation between the divisions that conduct the investigation and propose the sanctions, and the deciding body, the Commission itself, notwithstanding the fact that the final determination can be—and was—challenged in court. The possibility to challenge the sanctions in court, in fact, it was not considered sufficient to cure

Abusi di mercato, sanzioni Consob e diritti umani: il caso Grande Stevens e altri c. Italia, forthcoming in 693 RIVISTA DELLE SOCIETÀ 59 (2014).

the deficiencies of the sanctioning procedure administered by the Consob because the Italian Court of Appeal did not, according to the Strasbourg judges, hold any public hearing and did not allow the accused to fully produce their evidence (such as examining witnesses).

Secondly, and possibly more importantly for several European countries, the ECHR attacks the structure of the regulation, which provides that the same conducts can be punished both with an "administrative" sanction, and be the object of criminal prosecution. According to the Court this approach, which seems to be authorized by the European Directive on Market Abuse and is followed in different Member States, violates the principle of "*ne bis in idem*", or "*double jeopardy*", stating that none can be judged or punished twice for the same facts.

Even if technically the case concerns sanctions on market manipulation, not insider trading, similar principles are applicable to insider trading regulation.

The decision confirms a long list of precedents by the ECHR, and can affect deeply the enforcement of insider trading and market manipulation in Europe, also because both the legislature and the Stock Exchange Commissions of the Member States must act in accordance with European law. It's probably still early for a full discussion of this decision, and to predict all its intended and unintended consequences. Surely there are parts of the opinion that can and will be the object of extensive discussion. Needless to say, effective enforcement of the rules against market manipulation is a pillar of investors' protection, and one can only hope that both regulatory agencies and courts can actively prosecute violations; but the Court underlines the relevance of the European Convention on Human Rights also in the highly technical area of financial markets regulation.

4. Comparing Insider Trading Regulation in the U.S. and the E.U.

4.1. Comparing Substantive Provisions: U.S. vs. the European Union

In the light of the preceding discussion, we can now draw some conclusions on the comparison between the substantive U.S. and E.U. rules on insider trading. The starting point is that the American prohibition is largely based on the violation of a fiduciary duty (even if, as mentioned, some exceptions exist), while the European approach embraces the concept of equal access to information. The U.S. reliance on breaches of fiduciary duties has been adopted to limit the potentially very broad reach of the equal access to information approach. This different approach is also mirrored in the connected area of disclosure obligations of reporting corporations: in the U.S. we do not find a

general duty to disclose all material information similar to the corresponding European rule.

The "price" of the American regulatory strategy, however, is a somehow fragmented and contradictory system in which the plaintiff must generally be able to establish the existence of a fiduciary duty and the fact that it has been breached. The European approach, on the other hand, is broader and enforcement actions do not need to jump through the same legal loopholes to successfully argue a violation of insider trading prohibitions.

Notwithstanding these "philosophical" differences in the rationale underlying insider trading regulation, when we look at the practical implications of American and European rules, in particular with respect to the scope of application of insider trading, the two systems are more similar than they might appear. There are for sure situations in which E.U. rules would apply, but American ones would not, and possibly vice-versa, but they are fairly limited and they concern, in particular, tippees.[152]

Probably the most significant distinction concerns the burden of the proof, since in the U.S. in most instances it is necessary to prove a breach of a fiduciary duty and, in the case of tippees, the awareness of the breach.

On the other hand, another important difference is that in Europe there are no rules similar to Section 16(b) of the Exchange Act. This prophylactic provision empowers American investors with a particularly effective, if crude, tool to sanction the most egregious (possible) insider trading violations of primary insiders through private litigation. Public enforcement, on the other hand, is the almost exclusive remedy, or at least the most commonly used one, available in most European countries.

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[152] As mentioned in the Introduction, this Article focuses on the general differences between the U.S. approach and the European one as regulated at the E.U. level. Of course additional differences could be pointed out focusing on the ways in which European law has been implemented in different Member States. For an historical overview of insider trading regulation in some European jurisdictions
Victor F. Calaba, *The Insiders: A Look at the Comprehensive and Potentially Unnecessary Regulatory Approaches to Insider Trading in Germany and the United States, Including the SEC's Newly Effective Rules 10b5-1 and 10b5-2*, 23 LOY. L.A. INT'L & COMP. L. REV. 457 (2001); Carol Umhoefer & Alain Pietrancosta, *Le Delit D'Initie: Insider Trading Law in France*, 30 COLUM. J. TRANSNAT'L L. 89 (1992);
Alexander Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 AM. J. COMP. L. 123 (2006). In this work, however, the emphasis in on the general differences between the harmonized European rules and the U.S. approach, not on the technicalities of the differences that can emerge considering single specific jurisdictions within the European Union.

4.2. Public and Private Enforcement of Insider Trading in the U.S. and Europe

Enforcement of insider trading prohibitions can use different channels. In the U.S., the SEC can bring administrative actions against insiders, but can also sue in federal courts and defer alleged violation to the Department of Justice for criminal prosecution. Additionally, private plaintiffs also have a cause of action against insiders, and in this respect they often rely on Section 16(b) of the Exchange Act, rather than on Rule 10b-5, in the light of the lower burden of the proof provided by the former. Interestingly enough, as also anecdotally demonstrated by the list of leading cases discussed in above, "[d]espite explicit congressional action authorizing a cause of action for those who trade contemporaneously with an insider, private enforcement of insider trading is small and the heavy lifting has been left to the SEC and Justice Department".[153] The reason for the prevalence of public enforcement is that insider trading, in particular cases based on Rule 10b-5, is very difficult to prove: simple discovery instruments available to private litigants are not particularly effective to collect the necessary evidence, while the SEC and the attorney general obviously have more extensive investigative powers. In addition, evidence in this area is almost always entirely circumstantial; often the fact-finders need to derive reasonable inferences from apparently innocuous circumstances to reach the conclusion that the prohibition was violated. The high degree of uncertainty in these cases discourages private litigants and their attorneys, as opposed to regulatory agencies and prosecutors for which repression of financial misconducts is a primary and explicit goal.[154]

A distinctive feature of insider trading enforcement in the U.S. is its multifaceted structure. The violation of insider trading rules can result in both administrative and criminal sanctions, and in private penalties. Enforcement actions can, at least in principle, be brought by the SEC, the Department of Justice, and private litigants. This multifaceted structure of possible sanctions is also present in Europe. In most jurisdictions insider trading can lead to both criminal and administrative consequences and, at least in theory, private causes of action are also available; as we have mentioned, however, the *Grande Stevens v. Italy* case recently decided by the European Court of Human Rights chastises the

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[153] Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 298 (1999). *See* also John C. Coffee Jr., *Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281 (2013), footnote 3, observing that "insider trading is seldom enforced through private litigation, but instead through criminal and SEC enforcement."

[154] *See* Thomas C. Newkitk – Melissa A. Robertson, *Insider Trading – A U.S. Perspective*, available at http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

application of both administrative and criminal sanctions as violating double jeopardy.

Are there, however, different enforcement patterns in Europe and in the U.S.? More specifically, is repression of insider trading more aggressively and successfully pursued in the U.S. than in Europe?

John Coffee has provided extensive evidence indicating an apparently staggering difference in the level of public and private enforcement of insider trading violations in the U.K. and in the U.S.[155] For example, according to the data reported in his study, between 2001 and 2006 the SEC brought over 300 insider trading enforcement actions against over 600 individuals and entities. In the same period of time, the Federal Bureau of Investigation has indicated that it has been involved in an average of roughly 55 insider trading cases a year prosecuted by the Department of Justice, resulting in 88 convictions in the six years considered. According to newspaper reports, from 2001 to 2007 the U.K. regulator, the Financial Securities Agency (FSA) has successfully brought only 8 cases alleging insider trading.[156] From 2005 and 2012 Consob, the Italian Securities and Exchange Commission, has investigated 25 insider trading cases, an average of approximately 3 cases a year.[157] In 2007, one of the years in which the Italian Commission has been more active in prosecuting insider trading, it joined as a private party 12 criminal cases alleging insider trading; of these 12, only 4 resulted in a conviction.[158] The German financial supervisory authority, the BaFin, seems more active in prosecuting insider trading: in 2005 it started 54 new investigations, referring 23 cases to prosecutors.[159]

While the difference in absolute terms appears profound, once we take into account the dimensions of the different national markets, both in terms of number of reporting corporations and of market capitalization, it becomes questionable that all European authorities are significantly less active than their American counterparts in prosecuting insider trading. For example if one considers that in the U.S. there are around 5,000 listed corporations, and that in Italy there are less than 300, the disproportion between enforcement activities of the SEC and of Consob fades. It is probably true, however, also according to anecdotal evidence, that the severity of the criminal or administrative sanctions inflicted in the U.S. and Europe is different, the formers being significantly higher.[160]

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[155] Coffee note 1, 263 ff.
[156] *Id.* at 265.
[157] Relazione Consob 2013 available on www.consob.it, at 196.
[158] *Id.* at 202.
[159] Coffee note 1, at 280.
[160] *Id.*, at 266.

One possible additional difference in terms of public enforcement can be attributed to regulatory style. In his study comparing enforcement of securities laws around the world, John Coffee uses the percentage of the budget spent on enforcement of different regulatory agencies as a proxy for their relative use of *ex post* enforcement or other regulatory mechanisms (such as auditing of regulated firms).[161] He finds that the SEC is an outlier in terms of amount of resources dedicated to enforcement.

Another important and very recent difference concerning public enforcement (criminal and administrative) might derive from the ECHR's decision in the above-mentioned *Grande Stevens and others v. Italy* case. This judgment might affect the ability of European Member States to cumulate administrative and criminal sanctions aimed at punishing the same conducts.

When we shift our attention to private enforcement, we also find interesting comparative differences between the U.S. and Europe. It is certainly true that, as mentioned above, even in the U.S. the bulk of insider trading enforcement is carried on by the SEC and criminal prosecutors. Private enforcement however is far from non-existing, especially litigation based on Section 16(b) of the Exchange Act which, as we have seen, offers a fairly accessible remedy to investors suing primary insiders.

On the other hand, private enforcement of the securities laws in Europe is much more limited. Of course, there are exceptions, and in some jurisdictions civil liability for insider trading appears to be more aggressively and successfully enforced: this is, for example, the case of Germany.[162] In particular, in several European civil law countries well known procedural obstacles create a powerful disincentive to private litigants in the E.U.: the absence of U.S.-style class actions,[163] the "loser-pays" rule, the unavailability in most situations and jurisdictions of contingency fees and, last but not least, the absence of effective discovery obligations make private causes of actions significantly less attractive.[164] This is particularly true in the area of insider trading where, as mentioned, the evidence is often circumstantial and very difficult to obtain for a

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[161] *Id.* at 277.

[162] For a discussion of this issue, including but not limited to financial markets law, *see* Thomas M. J. Möllers – Bernhard Pregler, *Civil Law Enforcement and Collective Redress in Economic Law*, in 2013 EUROPA E DIRITTO PRIVATO 27 (2013).

[163] See Linda A. Willett, *US-Style Class Actions in Europe: A Growing Threat?*, 9 NAT'L LEGAL CENTER PUB. INT. 1, 2 (2005).

[164] For a discussion on barriers to private litigation in the related field of antitrust, but with observations that can be extended to securities litigation generally and insider trading in particular, *see* The Ashurst Report, *Study on the Conditions of claims for damages in case of infringement of EC competition rules*, (August 2004), available at: http://ec.europa.eu/competition/antitrust/actionsdamages/comparative_report_clean_en.pdf

private litigant lacking the searching powers of public agencies and prosecutors. In addition, the fact that rules similar to the American prohibition against short-swing profits are not available further discourages private litigation.

One final possible explanation of the difference in enforcement between the U.S. and Europe is the general duty to disclose all material information that characterizes E.U. law. To the extent that it can be argued that compliance with this duty imposes the immediate disclosure of private information, this substantive rule might reduce the possibility of committing insider trading.

4.3. Conclusions

As with many other securities law issues, also with respect to insider trading it could be argued that U.S. regulation has both the advantages and the disadvantages of the "first comer". The U.S. was the first country engaging in both public and private enforcement of insider trading. In doing so, it relied primarily on two provisions: Section 16(b) of the 1934 Exchange Act, and Section 10(b) of the same Act and Rule 10b-5 thereunder. The first is a clear-cut, preventive rule easy to apply but narrow in its scope. It is helpful in discouraging the most egregious insider trading by primary insiders, but it relies on a presumption of use of inside information. Section 10(b) and Rule 10b-5, on the other hand, are catch-all anti-fraud provisions characterized by a very broad scope of application, but do not specifically regulate insider trading; in fact, they do not even mention it. The regulation of insider trading derived from these provisions is primarily based on case law and administrative regulation and enforcement by the SEC. In a typical common law fashion, the resulting legal framework is complex and sometimes contradictory, and it can fully be understood only considering its historical evolution.

The European Union, on the other hand, was a relatively "late comer" to the regulation of insider trading. The regulation was enacted primarily through the use of directives at the European level, therefore ensuring a certain degree of harmonization – not complete, but substantial – among different Member States. European rules tackle the issue of insider trading more explicitly and directly than their U.S. statutory counterparts, therefore resulting in a more clear, systematic and probably straightforward approach.

At the substantive level, the pivotal difference is that U.S. courts, and the Supreme Court in particular, decided to base the prohibition of insider trading on the violation of fiduciary duties. This device was mainly motivated by the concern to broaden excessively the scope of insider trading, with possible chilling effects on financial markets. It is true that more recently the U.S. approach seems

to have somehow softened the "fiduciary-duty-based" theory of insider trading, especially through the misappropriation theory, but fiduciary duties remain a crucial concept to understand U.S. insider trading laws. On the other hand, Europe has embraced the parity-of-information approach, which basically condemns any trading while in possession of private, price-sensitive information.

The latter approach might be considered preferable to foster efficient markets, if it is true, as some research indicates, that "[C]ountries with more prohibitive insider trading laws have . . . more accurate stock prices, and more liquid stock markets. These findings are generally robust to control for measures of disclosure and enforceability and suggest that formal insider trading laws (especially their deterrence components) matter to stock market development."[165] A statutory adoption of the parity-of-information theory of insider trading in the U.S. is not impossible, but it seems unlikely due to the fact that it would require a complete overhaul of the regulation in this area, to the path-dependency of the legal system, and to the fact that, notwithstanding its complexity, insider trading enforcement in the U.S. is far from being inadequate and, in fact, it still appears to many as more effective than in Europe. In fact, enforcement activity is rising also in Europe, but especially private enforcement is still fairly weak on the eastern side of the Atlantic.

One final insight of this Article is that, notwithstanding the almost opposite underlying philosophies of insider trading in the U.S. and in Europe, from a practical point of view there is not a dramatic divergence concerning the scope of application of the prohibition, even if probably the burden of the proof in Rule 10b-5 actions is higher in the U.S., especially with respect to breach of a fiduciary duty and scienter.

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[165] Laura Nyantung Beny, *Do Insider Trading Law Matter? Some Preliminary Comparative Evidence,* 7 AM. L. & ECON. REV. 144, 144 (2005).