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THE REGULATION OF INSIDER TRADING IN THE EUROPEAN COMMUNITY

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I. INTRODUCTION

The European Community (EC), as part of its mandate under the Treaty of Rome[1] to create a single internal market by 1992,[2] has enacted an EC-wide prohibition on insider trading.[3] The EC's "Council Directive Coordinating Re-

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1. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter Treaty of Rome]. The founding members of the EC were Belgium, France, Italy, Luxembourg, the Netherlands and West Germany, which had previously formed the European Coal and Steel Community. *See generally* D. WYATT & A. DASHWOOD, THE SUBSTANTIVE LAW OF THE EEC (1987). They were joined by Denmark, Ireland, and the United Kingdom in 1973, Greece in 1981, and Spain and Portugal in 1986. *Id.* The Treaty of Rome, establishing the European Economic Community, often referred to as the common market, is a constitutional document by nature. Its articles are divided into six areas: (1) Principles of the Community, articles 1-8; (2) Foundations of the Community, articles 9-84; (3) Policy of the Community, articles 85-130; (4) The Association of Overseas Countries and Territories, articles 131-136; (5) Institutions of the Community, articles 137-209; and (6) General and Final Provisions, articles 210-248. 1 Common Mkt. Rep. (CCH) ¶¶ 121.01-.95.

2. The EC's 1992 program originally was outlined in the EC Commission's special report, COMPLETING THE INTERNAL MARKET: WHITE PAPER FROM THE COMMISSION TO THE EUROPEAN COUNCIL (1985). The white paper addressed a broad range of issues and proposed some 300 directives, legislative mandates to the member states, designed to produce a high degree of regulatory harmony in the common market. The Single European Act, 30 O.J. EUR. COMM. (No. L 169) 1 (1987), 3 Common Mkt. Rep. (CCH) ¶ 21,000 [hereinafter Single European Act], amending the Treaty of Rome, embraced these proposals and the December 31, 1992 goal for a single market "without internal frontiers in which the free movement of goods, persons, services and capital is ensured." Treaty of Rome, *supra* note 1, art. 8(a). *See generally* M. CALINGAERT, THE 1992 CHALLENGE FROM EUROPE: DEVELOPMENT OF THE EUROPEAN COMMUNITY'S INTERNAL MARKET (1988); P. CECCHINI, THE EUROPEAN CHALLENGE 1992: THE BENEFITS OF A SINGLE MARKET (1988); M. EMERSON, THE ECONOMICS OF 1992: THE EC COMMISSION'S ASSESSMENT OF THE ECONOMIC EFFECTS OF COMPLETING THE INTERNAL MARKET (1988); Anderson, *Inadequate Implementation of EEC Directives: A Roadblock on the Way to 1992?*, 11 B.C. INT'L & COMP. L. REV. 91 (1988); Jones, *Putting '1992' In Perspective*, 9 NW. J. INT'L L. & BUS. 463 (1989); Meessen, *Europe en Route to 1992: The Completion of the Internal Market and Its Impact on Non-Europeans*, 23 INT'L LAW. 359 (1989).

3. Council Directive 89/592 Coordinating Regulations on Insider Dealing, 32 O.J. EUR. COMM. (No. L 334) 30 (1989), 1 Common Mkt. Rep. (CCH) ¶ 1761 [hereinafter Insider Trading Directive].

From the date the Insider Trading Directive was first proposed, numerous articles have been written detailing its provisions. *See generally* Appel & Wegen, *The EEC Directive on Insider Trading*, 22 REV. SEC. & COMMODITIES REG. 137 (1989) ; Cruickshank, *Insider Trading in* gulations on Insider Dealing"[4] (Insider Trading Directive) is a *mandatory* model

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the EEC, 10 INT'L BUS. LAW. 345 (1982); Dine, *The Insider Trading Directive*, 22 L. Soc'y Gaz., June 7, 1989, at 23; Fornasier, *The Directive on Insider Dealing*, 13 FORDHAM INT'L L.J. 149 (1989-90); Hannigan, *Regulating Insider Dealing: The EEC Dimension*, 1 J. INT'L BUS. L. 11 (1989); Hopt, *The European Insider Dealing Directive*, 27 COMMON MKT. L. REV. 51 (1990) [hereinafter Hopt, *European Directive*]; Schodermeir & Wallach, *The EEC Insider Directive Approaching Final Adoption*, 5 J. INT'L BUS. L. 234 (1989); Warren, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L. J. 185 (1990); Comment, *Insider Trading and the EEC: Harmonization of the Insider Trading Laws of the Member States*, 8 B.C. INT'L COMP. L. REV. 151 (1985); Note, *Toward the Unification of European Capital Markets: The EEC's Proposed Directive on Insider Trading*, 11 FORDHAM INT'L L.J. 432 (1988) [hereinafter Note, *Toward Unification*]; Note, *Securities—Insider Trading— The Effects of the New EEC Draft Insider Trading Directive*, 18 GA. J. INT'L & COMP. L. 119 (1988); Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377 (1989); Note, *A Comparative Analysis of the European Community Insider Trading Directive*, 3 TRANSNAT'L LAW. 231 (1990) [hereinafter, Note, *A Comparative Analysis*]; Note, *A New Look at the European Economic Community Directive on Insider Trading*, 23 VAND. J. TRANSNAT'L L. 135 (1990) [hereinafter, *Note, A New Look*].

In addition, in recent years insider trading regulation under various national laws has been the subject of much commentary. *See generally* Banoff, *The Regulation of Insider Trading in the United States, United Kingdom and Japan*, 9 MICH. Y.B. INT'L LEGAL STUD. 145 (1988); Blum, *The Regulation of Insider Trading in Germany: Who's Afraid of Self-Restraint?*, 7 NW. J. INT'L L. & BUS. 507 (1986); Bornstein & Dugger, *International Regulation of Insider Trading*, 1987 COLUM. BUS. L. REV. 375; Briner, *Insider Trading in Switzerland*, 10 INT 'L BUS. LAW. 348 (1982); Duhot, *French Regulations on Disclosure Obligations and on Insider Trading*, 2 INT'L BUS. LAW. 96 (1974); Hawes, Lee & Robert, *Insider Trading Law Developments: An International Analysis*, 14 LAW & POL'Y IN INT'L BUS. 335 (1982); Herne, *Inside Information: Definitions in Australia, Canada, the U.K. and the U.S.*, 8 J. COMP. BUS. & CAP. MKT. L. 1 (1986); Hopt, *Insider Trading on the Continent*, 4 J. COMP. CORP. L. & SEC. REG. 379 (1982); Hopt, *The German Insider Trading Guidelines—Spring-Gun or Scarecrow?*, 8 J. COMP. BUS. & CAP. MKT. L. 381 (1986) [hereinafter Hopt, *German Guidelines*]; Houle, *Survey of National Legislation Regulating Insider Trading*, 9 MICH. Y.B. INT'L LEGAL STUD. 209 (1988); Huss & Leete, *Insider Trading Regulations: A Comparison of Judicial and Statutory Sanctions*, 25 AM. BUS. L.J. 301 (1987); Ishizumi, *Insider Trading Regulation: An Examination of Section 16(b) and a Proposal for Japan*, 47 FORDHAM L. REV. 449 (1979); Kraus, *Securities Regulation in Germany? Investors' Remedies for Misleading Statements by Issuers*, 18 INT'L LAW. 109 (1984); Lee & Bishara, *Securities Regulation and Market Efficiency*, 5 INT'L REV. L. & ECON. 247 (1985); Lightburn, *Insider Trading in France*, 7 INT'L FIN. L. REV. 23 (1988); Lowenfeld, *Bank Secrecy and Insider Trading: The Banca della Svizzera Italiana Case*, 15 REV. SEC. REG. 942 (1982); Patterson, *Insider Trading and Business Ethics*, 1984 N.Z.L.J. 369; Pillai, *Insider Trading in Singapore and Malaysia*, 16 MALAYA L. REV. 333 (1974); Rosenbaum, Simmonds, Simpson & Vaidila, *Corporate and Investment Attitudes Towards Insider Trading in Canada*, 8 CAN. BUS. L.J. 485 (1984); Rundfelt, *Insider Trading: Regulation in Europe*, 10 J. ACCT., AUD. & FIN. 125 (1986); Sarna, *Japan and Insider Trading: Some Problems When There Are Different Definitions of Right and Wrong*, 14 ILSA J. INT'L L. 67 (1990); Shimada & Rose, *Japan's New Penal Provisions Concerning Insider Trading*, 3 BUTTERWORTHS J. INT'L BANKING & FIN. L. 462 (1988); Sorin, *The Regulation of Trading by Insiders and Obligations to Disclose in the United States*, 2 INT'L BUS. LAW. 81 (1974); Tatsuta, *Enforcement of Japanese Securities Legislation*, 1 J. COMP. CORP. L. & SEC. REG. 95, 112 (1978); Tunc, *The Reform of French Insider Trading Law*, 4 COMPANY LAW. 205 (1983); Wallace, *Who Is Subject to the Prohibition Against Insider Trading: A Comparative Study of American, British and French Law*, 15 SW. U.L. REV. 217 (1985); Zoglin, *Insider Trading in Japan: A Challenge to the Integration of the Japanese Equity Market into the Global Securities Market*, 1987 COLUM. BUS. L. REV. 419; Comment, *Recent* act[5] setting forth the minimal regulatory prohibition that must be implemented by national legislation in all twelve EC member states by June 1, 1992.[6] The directive, in essence, requires each of the member states to prohibit two defined groups of persons, referred to as primary and secondary insiders, from taking advantage of nonpublic, price-sensitive information relating to issuers or their securities; to prohibit primary insiders, a group which excludes tippees, from disclosing that information, explicitly or implicitly, to others; and to mandate prompt public disclosure of all price-sensitive information by firms whose securities are publicly traded in a regulated market. The directive, a hybrid modeled largely on the insider trading laws of France[7] and the United Kingdom,[8] is intended to level the playing field for market participants and to promote investor confidence in the newly-integrated securities markets of the member states.[9]

Developments in Insider Trading Laws and Problems of Enforcement in Great Britain, 12 B.C. INT'L & COMP. L. REV. 265 (1989); Note, *Insider Trading and the Internationalization of the Securities Markets*, 27 COLUM. J. TRANSNAT'L L. 409 (1989); Note, *Regulation of Insider Trading in Hong Kong*, 10 HASTINGS INT'L & COMP. L. REV. 647 (1987); Note, *A Comparative Analysis of Insider Trading Laws: The United States, the United Kingdom and Japan—The Current International Agreements on Securities Regulation*, 13 SUFFOLK TRANSNAT'L L.J. 167 (1989); Comment, *West German Bank Secrecy: A Barrier to SEC Insider-Trading Investigations*, 20 U. CAL. DAVIS L. REV. 609 (1987); Note, *Icarus and His Waxen Wings: Congress Attempts to Address the Challenges of Insider Trading in a Globalized Securities Market*, 23 VAND. J. TRANSNAT'L L. 99 (1990).

4. Insider Trading Directive, *supra* note 3.

5. The Treaty of Rome provides for EC legislation, either in the form of regulations or directives, requiring the member states to enact prescribed domestic legislation. Treaty of Rome, *supra* note 1, art. 100. The Treaty states that "[a] directive shall be binding, as to the result to be achieved, upon each member state to which it is addressed, but shall leave the national authorities the choice of forms and methods." *Id.* art. 189. Directives are "the classic method of integrating Community policy into the national law of the member states." Thieffry, Van-Doorn & Lowe, *The Single European Market: A Practioner's Guide to 1992*, 12 B.C. INT'L & COMP. L. REV. 357, 360 (1989). The "overwhelming proportion" of the EC's efforts to harmonize member state laws in the fields of corporate and securities laws have taken the form of directives.` R. BUXBAUM & K. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE: CORPORATE AND CAPITAL MARKET LAW, HARMONIZATION POLICY IN EUROPE AND THE U.S.A. 232 (INTEGRATION THROUGH LAW: EUROPE AND THE AMERICAN FEDERAL EXPERIENCE vol. 4, 1988) [hereinafter BUXBAUM & HOPT]. On directives generally, see Bieber, *Legislative Procedure for the Establishment of the Single Market*, 25 COMMON MKT. L. REV. 711 (1988).

6. Insider Trading Directive, *supra* note 3, art. 14.

7. Ordonnance No. 67-833 du 28 septembre 1967, art. 10, J.O., Sept. 29, 1967, at 9589, 1967 D.S.L. 373. The current provision, Article 10-1, was amended to the Ordonnance by Loi No. 70-1208 du 23 décembre 1970, art. 4, J.O., Dec. 24, 1970, at 11891, 1971 D.S.L. 17; *amended by* Loi No. 82-1172 du 31 décembre 1982, art. 35, J.O., Jan. 1, 1983 at 15, 1983 D.S.L. 86; *also amended by* Loi No. 88-70 du 22 janvier 1988, art. 16, J.O., Jan. 23, 1988, at 1111, 1988 D.S.L. 133. The Commission des Operation de Bourse (COB) recently adopted a set of insider trading regulations, although its statutory authority has been questioned. *See COB Draws Up Tougher Insider Trading Rules*, 3 Int'l Sec. Reg. Rep. (BNA) No. 12, at 2 (May 21, 1990).

8. The Companies Act, 1980, ch. 22; *reenacted*, Company Securities (Insider Dealing) Act, 1985, ch. 8; *amended*, Financial Services Act, 1986, ch. 60, which allows civil remedies. *See* Note, *Toward Unification*, *supra* note 3, at 432.

9. Insider Trading Directive, *supra* note 3, preamble.

The EC hardly succeeds in these purposes. The directive grants the member states a wide margin of discretion in their transformation of the directive into their own national laws. It fails to label insider trading as a crime and expressly prescribes no penalties or civil remedies. Seen in the best light, the directive establishes a new moral: Insider trading is now, for the first time, a European sin and, henceforth, a public wrong for market participants. Seen in the worst light, the directive merely assists the EC in its promotion of a dangerous imagery of regulation: the directive's denunciation of insider trading conveys the false impression of a comprehensively-regulated marketplace. This image, framing the EC's regulatory system as a paragon of regulatory virtue, recommends the EC's marketplace to the international investment community and to regulatory authorities, particularly those in the United States, who are under increased political pressure to accord reciprocal treatment to EC firms.[10]

Before exploring the legislative development of the Insider Trading Directive and its specific prohibitions, one should first take notice of the traditions it ostensibly would circumscribe. When the EC Commission first initiated deliberations on an insider trading directive in 1976,[11] only France had enacted a prohibition,[12] and even there it was rarely, if ever, enforced.[13] At the time the directive was actually proposed four years ago, only three member states—France, the United Kingdom and Denmark—had proscribed insider trading as a crime.[14] The other nine countries in the EC had either voluntary schemes or no regulation at all. Indeed, prior to the 1980's, securities regulation in the common market, at least outside Great Britain, was virtually non-existent.[15] Clearly, as one writer has noted, "the rest of the world doesn't share American revulsion to insider trading, nor do other countries give their regulators strong powers or resources to ferret out wrongdoers."[16] According to an EC official, insider trading "is considered a very normal consequence, and not a bad thing

10. Warren, *Euroequity Offerings: A Preliminary Note on Worldwide Regulatory Harmony*, 5 GESTION 2000 MANAGEMENT & PROSPECTIVE 17 (1989) [hereinafter Warren, *Euroequity Offerings*].

11. *See infra* note 40 and accompanying text.

12. *See supra* note 7. The French law prohibits two types of individuals from trading on inside information: "Direct" and "indirect" insiders. Direct insiders generally include executives and their spouses. Indirect insiders include all others, who as a result of their profession, have access to inside information. Note, *Toward Unification, supra* note 3, at 440-41. While both of these categories are covered by the directive, French law traditionally has not provided a corresponding prohibition against tippees. *Id.* In addition, under the 1970 law, only individuals, not corporations, can be guilty of insider trading. Note, *A New Look, supra* note 3, at 159.

13. The COB, charged with enforcement of the French prohibition, has not been viewed as an effective regulatory agency. As one writer described the agency, "[a]s stockmarket watchdog, it bites with its gums." *A Pungent French Tale of Socks and Shares*, ECONOMIST, Feb. 4, 1989, at 43 [hereinafter *A Pungent French Tale*].

14. Commission Proposal for a Council Directive Coordinating Regulations on Insider Trading, 30 O.J. EUR. COMM. (No. C 153) 8 (1987) (explanatory memorandum, para. 2, at 2) [hereinafter First Proposal].

15. Interview with Professor L.C.B. Gower, in London (Nov. 21, 1988).

16. Putka, *Insider Trading Raises Fewer Hackles Abroad*, Wall St. J., Dec. 2, 1986, at 36, col. 1.

to profit from information you happen to have."[17] It is hard to disagree with the statement that "insider trading is rampant in Europe,"[18] an observation borne out in a number of highly-publicized recent scandals.[19] No one in Europe, even in those few states that have criminalized insider trading, has ever gone to jail for it.[20] Insider trading is endemic in Italy, France and Spain, countries described by one investment banker as "cowboy country."[21] Insider trading in Germany has been viewed "simply as a lucky tip."[22] As an *Economist* survey wryly observed, "West Germany and France assumed until recently that insider trading was what financial life was all about."[23] These reflections illustrate a tradition, a set of widely-held attitudes, shared by both the regulated, the regulators and the courts,[24] that likely will prove resistant to the behavioral modification the Insider Trading Directive seeks to accomplish.

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17. Forman, *Old World Traditions Include Insider Trading*, Wall St. J., Feb. 8, 1989, at C1, col. 3.

18. *Id.*

19. *See, e.g.*, A. ROUTIER, LA REPUBLIQUE DES LOUPS (1989); G. SENGÈS & F. LABROUILLÈRE, LA PIÈGE DE WALL STREET (1989); *A Pungent French Tale*, *supra* note 13; *Lark de Triomphe*, ECONOMIST, Jan. 28, 1989, at 77; Studer, *Swiss Banker Bought Suchard Stock Before Bid*, Wall St. J., Jan. 4, 1991, at A4, col. 3; Browning, *France Wants 5 to Be Charged in Insider Case*, Wall St. J., May 31, 1990, at A11, col. 4; *London's Stock Exchange Probes Possible Targets of Bank Raids*, Wall St. J., Nov. 7, 1990, at C1, col. 4; Kamm, *Five Indicted in France for Trading of Triangle Shares During Takeover*, Wall St. J., Feb. 17, 1989, at A11, col. 2; Greenhouse, *Modest Insider-Trading Stir Is a Huge Scandal in France*, N.Y. Times, Jan. 30, 1989, at D1, col. 1; Betts, *'Mole' Hunt in French Insider-Dealing Case*, Fin. Times, Jan. 20, 1989, at 2, col. 1; Toman & Forman, *Dismissals for Alleged Insider Trading Trip Up NatWest's Investment Bank*, Wall St. J., Aug. 15, 1988, at 16, col. 5; Ricks, *Insider Trading Charges Filed Against Collier*, Wall St. J., July 27, 1988, at 4, col. 1; Forman, *Britain Moves Closer to Decision On Insider Cases*, Wall St. J., Mar. 7, 1988, at 23, col. 1; *Guinness Takes $200M Charge Due to Boesky*, Newsday, Apr. 24, 1987, at 45, col. 1; Lohr, *Guinness Scandall Roils Britain*, N.Y. Times, Jan. 30, 1987, at D1, col. 3; *U.K. Launches an Investigation into Guinness*, Wall St. J., Dec. 2, 1986, at 37, col. 1; Lohr, *Ouster at London Stock Firm*, N.Y. Times, Nov. 12, 1986, at D5, col. 1.

20. Forman, *supra* note 17. It must be conceded, of course, that no one ever went to jail for insider trading before the golden anniversary of the federal statute. *The Insider Trading Sanctions Act of 1984: Hearings Before the Subcommittee on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 40 (1984) (statement of Senator Proxmire).

21. Forman, *supra* note 17.

22. *Insider Trading Law Possible, Says Exchange Chief Von Rosen*, 2 Int'l Sec. Reg. Rep. (BNA) No. 9, at 3-4 (Apr. 12, 1989). Under Germany's *voluntary* insider trading guidelines, "scandals are quickly swept under the carpet," and "critics claim there is a widespread bending of the rules." *German Insider Trading: Behind the Times*, ECONOMIST, July 13, 1991 at 86. German officials, in the wake of recent insider trading allegations against Deutsche Bank staff, have conceded that hopes for Germany to become a major international marketplace "are slim if foreigners reckon that Germany is more ready than its competitors to tolerate insider-manipulated markets." *Id.* Although Germany "reluctantly accepted" the Insider Trading Directive, "so far the Germans have not made clear just how tough they plan to be." *Id.*

23. *A Survey of Europe's Internal Market*, ECONOMIST, July 8, 1989, at 15 [hereinafter ECONOMIST 1992 SURVEY].

24. *See Insider Trading in Europe: A Daft Draft*, ECONOMIST, May 20, 1989, at 86 [hereinafter *A Daft Draft*]. According to the author, one of the major enforcement problems is

Traditions, however, are not immutable. The EC deserves considerable recognition for its surprising achievements during the last ten years. Its primary goal has been the harmonization of twelve widely disparate regulatory regimes, thereby eliminating regulatory obstacles to a unified European financial market. In its pursuit of harmony, the EC initially sought to establish *commonality*,[25] or a set of uniform or substantially equivalent rules. To hasten the pace, the EC moved to the *reciprocity* approach,[26] establishing substantially equivalent minimum standards and mandating mutual recognition by each member state of the regimes enacted by others. In the field of corporate law, the EC has adopted directives governing corporate formation,[27] mergers,[28] financial statements,[29] and auditors.[30] In the field of securities law, the EC has adopted direc-

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judicial attitude: "Some judges still treat insider trading as a gentlemanly misunderstanding rather than a crime." *Id.* at 87. Others may view the emergent "new morality" simply as a "struggle between *envy* and *greed*." J. DALHUISEN, THE NEW U.K. SECURITIES LEGISLATION AND THE E.C. 1992 PROGRAM 138 (1989).

25. Warren, *Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 198 (1990) [hereinafter Warren]. As opposed to the *reciprocity* approach, *commonality* sought to achieve harmonization among member states' laws through detailed common requirements, which proved to be politically infeasible. M. CALINGAERT, THE 1992 CHALLENGE FROM EUROPE: DEVELOPMENT OF THE EUROPEAN COMMUNITY'S INTERNAL MARKET 33, 53, 59 (1988). *See* Jones, *Putting "1992" in Perspective*, 9 NW. J. INT'L & BUS. L. 463, 469-70 (1989).

26. Warren, *supra* note 25, at 198. Directives proposed under the new *reciprocity* approach prescribe only basic, essential principles. *Id. See also* Roth, *The European Economic Community's Law on Services: Harmonization*, 25 COMMON MKT. L. REV. 35 (1988).

27. Council Directive 68/151 on the Coordination of Safeguards Which, for the Protection of the Interest of Members and Others, Are Required by Member States of Companies Within the Meaning of Article 58(2) of the Treaty, With a View to Making Such Safeguards Equivalent Throughout the Community, 11 O.J. EUR. COMM. (No. L 65) 8 (1968), 1 Common Mkt. Rep. (CCH) ¶ 1351; Council Directive 77/91 on Coordination of Safeguards, Which for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, With a View to Making Such Safeguards Equivalent, 20 O.J. EUR. COMM. (No. L 26) 1 (1977), 1 Common Mkt. Rep. (CCH) ¶ 1355.

28. Council Directive 78/855 Based on Article 54(3)(g) of the Treaty Concerning Mergers of Public Limited Liability Companies, 21 O.J. EUR. COMM. (No. L 295) 36 (1978), 1 Common Mkt. Rep. (CCH) ¶ 1361. *See also* Council Regulation 4064/89 on the Control of Concentrations Between Undertakings (Merger Control Regulation), 32 O.J. EUR. COMM. (No. L 395) 1 (1989), 2 Common Mkt. Rep. (CCH) ¶ 2839. *See generally* DeSmedt & Vandersanden, *The EC Merger Control Regulation*, 13 HASTINGS INT'L & COMP. L. REV. 437 (1990); Satzky, *The Merger Control Regulation of the European Economic Community*, 38 AM. J. COMP. L. 923 (1990).

29. Council Directive 78/660 Based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, 21 O.J. EUR. COMM. (No. L 222) 11 (1978), 1 Common Mkt. Rep. (CCH) ¶ 1371; Council Directive 82/891 Based on Article 54(3)(g) of The Treaty, Concerning the Division of Public Limited Liability Companies, 25 O.J. EUR. COMM. (No. L 378) 47 (1982), 1 Common Mkt. Rep. (CCH) ¶ 1411; Council Directive 83/349 Based on Article 54(3)(g) of the Treaty on Consolidated Accounts, 26 O.J. EUR. COMM. (No. L 193), 1 (1983), 1 Common Mkt. Rep. (CCH) ¶ 1421.

30. Council Directive 84/253 Based on Article 54(3)(g) of the Treaty on the Approval of Persons Responsible for Carrying out the Statutory Audits of Accounting Documents, 27 O.J. EUR. COMM. (No. L. 126) 20 (1984), 1 Common Mkt. Rep. (CCH) ¶ 1431.

tives governing admission to stock exchanges,[31] disclosures upon exchange listing,[32] interim reporting requirements,[33] prospectuses,[34] and mutual funds.[35] Together with the Insider Trading Directive and a proposed investment services directive,[36] these directives, as finally implemented by the member states, will form a supranational European securities code. This evolving regime represents a significant advance for both regulatory harmony and higher regulatory standards among the member states.[37]

This article will focus first on the legislative background of the Insider Trading Directive, from its origins in the European Code of Conduct[38] to the several drafts from which it emerged. Then the doctrinal basis underlying the directive's adoption will be examined, for the dual purposes of understanding the EC's policy objectives and of developing an interpretive framework. After discussing the directive's legislative development, the article will provide a detailed analysis of the directive's substantive prohibitions on trading and tipping, with particular emphasis on the definitions of "inside information" and "primary" and "secondary insiders." The analysis also will focus on the other elements of, as well as the various exclusions from, the trading and tipping offenses. Then, the issues of penalties, enforcement and multistate cooperation will be addressed. Finally, the article will reiterate the primary strengths of the directive, as well as its deficiencies, as the EC continues its quest for a harmonized securities regime for the common market.

II. The Legislative Background

The development of the Insider Trading Directive began almost fifteen years ago in 1976 when the Commission of the European Communities (Commis-

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31. Council Directive 79/279 Coordinating the Conditions for the Admission of Securities to Official Stock Exchange Listing, 22 O.J. Eur. Comm. (No. L 66) 21 (1979), 1 Common Mkt. Rep. (CCH) ¶ 1721, *amended* by Council Directive 82/148, 25 O.J. Eur. Comm. (No. L 62) 22 (1982) [hereinafter Admission Directive].

32. Council Directive 80/390 Co-ordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing, 23 O.J. Eur. Comm. (No. L 100) 1 (1980), 1 Common Mkt. Rep. (CCH) ¶ 1731.

33. Council Directive 82/121 on Information to be Published on a Regular Basis by Companies the Shares of Which Have Been Admitted to Official Stock-Exchange Listing, 25 O.J. Eur. Comm. (No. L 48) 26 (1982), 1 Common Mkt. Rep. (CCH) ¶ 1741.

34. Council Directive 89/298 Co-ordinating the Requirements for the Drawing-up, Scrutiny and Distribution of the Prospectus to be Published when Transferrable Securities are Offered to the Public, 32 O.J. Eur. Comm. (No. L 124/8) 8 (1989), 1 Common Mkt. Rep. (CCH) ¶ 1751. *See generally* Warren, *The Common Market Prospectus*, 26 Common Mkt. L. Rev. 687 (1989).

35. Council Directive 85/611 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), 28 O.J. Eur. Comm. (No. L 375) 3 (1985), 1 Common Mkt. Rep. (CCH) ¶ 1486.18, *amended by* Council Directive 88/220, 31 O.J. Eur. Comm. (No. L 100) 31 (1988).

36. Commission Proposal for a Council Directive on Investment Services in the Securities Field, 32 O.J. Eur. Comm. (No. C 43) 7 (1989), 1 Common Mkt. Rep. (CCH) ¶ 95028.

37. *See* Warren, *supra* note 25, at 224-26.

38. Commission Recommendation 77/534 Concerning a European Code of Conduct Relating to Transactions in Transferable Securities, 20 O.J. Eur. Comm. (No. L 212) 37 (1977), 1 Common Mkt. Rep. (CCH) 1602.33 [hereinafter European Code of Conduct].

sion)[39] formed a working party of experts to consider a common insider trading prohibition for adoption by the member states.[40] The following year, the Commission, asserting but, in fact, acting without the consensus of the member states, issued a formal recommendation entitled the "Commission Recommendation Concerning a European Code of Conduct Relating to Transactions in Transferable Securities" (European Code of Conduct).[41] It set forth the following as one of six general principles: "Any person, who by virtue of his profession or duties has the duty or the means of informing the public, is under a special obligation to ensure that it is kept properly informed, and that no particular class of persons attains a privileged position."[42] The European Code of Conduct, through a number of supplementary principles, advanced the Commission's ethic that insider trading should be prohibited by the member states.[43] The principle which would serve as a precursor to the directive's prohibition provided:

> Any person who comes into possession of information, in exercising his profession or carrying out his duties, which is not public and which relates to a company or to the market in its securities or to any event of general interest to the market, which is price-sensitive, should refrain from carrying out, directly or indirectly, any transaction in which such information is used, and should refrain from giving the information to another person so that he may profit from it before the information becomes public.[44]

Although clearly a blueprint for future securities regulation by the EC, the European Code of Conduct had little immediate impact on either the laws of various member states or the working party previously established. The Commission's formulation of business ethics, as set forth in the European Code of Conduct, "received a lukewarm reception when it was presented and is still relatively unknown to this day, even among ex-

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39. The Commission is composed of 17 members, appointed by mutual agreement among the governments of the member states. At least one national from each member state must be included, but no more than two may be of the same nationality. The Commission's most important function is to see that provisions of the Treaty are implemented. It has the power of initiative under the Treaty of Rome, thereby playing a prominent role in the shaping of measures taken by the Council and the Parliament. The composition, duties, and function of the Commission are governed by the Treaty of Rome, *supra* note 1, arts. 255-263. 3 Common Mkt. Rep. (CCH) ¶¶ 4472.01 - .07. *See generally* C. TUGENDHAT, MAKING SENSE OF EUROPE (1988).

40. *See* Cruickshank, *Insider Trading in the EEC*, 10 INT'L BUS. LAW. 345, 346 (1982).

41. European Code of Conduct, *supra* note 38. It is of interest to note that in the preamble to the European Code of Conduct, the Commission recited that the basic principles contained therein were "already widely recognized in all the countries of Europe." *Id.* But compare the preamble to the Insider Trading Directive, *supra* note 3, which recognizes that some member states have "no rules or regulations prohibiting insider dealing." Therefore, one must conclude that the Commission, in its recommended European *Code of Conduct*, was experiencing not reality but its hopes and dreams.

42. European Code of Conduct, *supra* note 38, at 41.

43. *Id.*

44. *Id.* at 42.

perts."[45] Nevertheless, the language of the Code's prohibition, with its marked similarity to the ultimate EC prohibitions on trading and tipping while in possession of nonpublic "market information," served as an important starting point.

The Commission, after over a decade of deliberation by the working party on numerous drafts, first proposed its insider trading directive on May 25, 1987 (First Proposal).[46] It did so despite the continual opposition of the Germans, who, preferring their own voluntary and toothless guidelines, were opposed to any legally binding harmonization in this area.[47] Pursuant to the EC's cooperation procedure[48] for the adoption of direc-

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45. BUXBAUM & HOPT, *supra* note 5, at 231.

46. First Proposal, *supra* note 14.

47. *See* BUXBAUM & HOPT, *supra* note 5, at 247; Hopt, *European Directive*, *supra* note 3, at 56; *see generally* Hopt, *German Guidelines*, *supra* note 3.

48. The EC's cooperation procedure was introduced by the Single European Act, *supra* note 2, and provides the framework for the cooperative enactment of EC laws by the Commission, which initiates proposals; the European Parliament, which has a consultative role; and the Council of Ministers, which makes the final decisions. The Act states:

> Where, in pursuance of this Treaty, the Council acts in co-operation with the European Parliament, the following procedure shall apply:
>
> (a) The Council, acting by a qualified majority under the conditions of paragraph 1, on a proposal from the Commission and after obtaining the Opinion of the European Parliament, shall adopt a common position.
>
> (b) The Council's common position shall be communicated to the European Parliament. The Council and the Commission shall inform the European Parliament fully of the reasons which led the Council to adopt its common position and also of the Commission's position.
>
> If, within three months of such communication, the European Parliament approves this common position or has not taken a decision within that period, the Council shall definitively adopt the act in question in accordance with the common position.
>
> (c) The European Parliament may within the period of three months referred to in point (b), by an absolute majority of its component members, propose amendments to the Council's common position. The European Parliament may also, by the same majority, reject the Council's common position. The result of the proceedings shall be transmitted to the Council and the Commission.
>
> If the European Parliament has rejected the Council's common position, unanimity shall be required for the Council to act on a second reading.
>
> (d) The Commission shall, within a period of one month, re-examine the proposal on the basis of which the Council adopted its common position, by taking into account the amendments proposed by the European Parliament.
>
> The Commission shall forward to the Council, at the same time as its re-examined proposal, the amendments of the European Parliament which it has not accepted, and shall express its opinion on them. The Council may adopt these amendments unanimously.
>
> (e) The Council, acting by a qualified majority, shall adopt the proposal as re-examined by the Commission.
>
> Unanimity shall be required for the Council to amend the proposal as re-examined by the Commission.
>
> (f) In the cases referred to in points (c), (d) and (e), the Council shall be required to act within a period of three months. If no decision is taken within this period, the

tives, the Commission presented the First Proposal to the EC's Council

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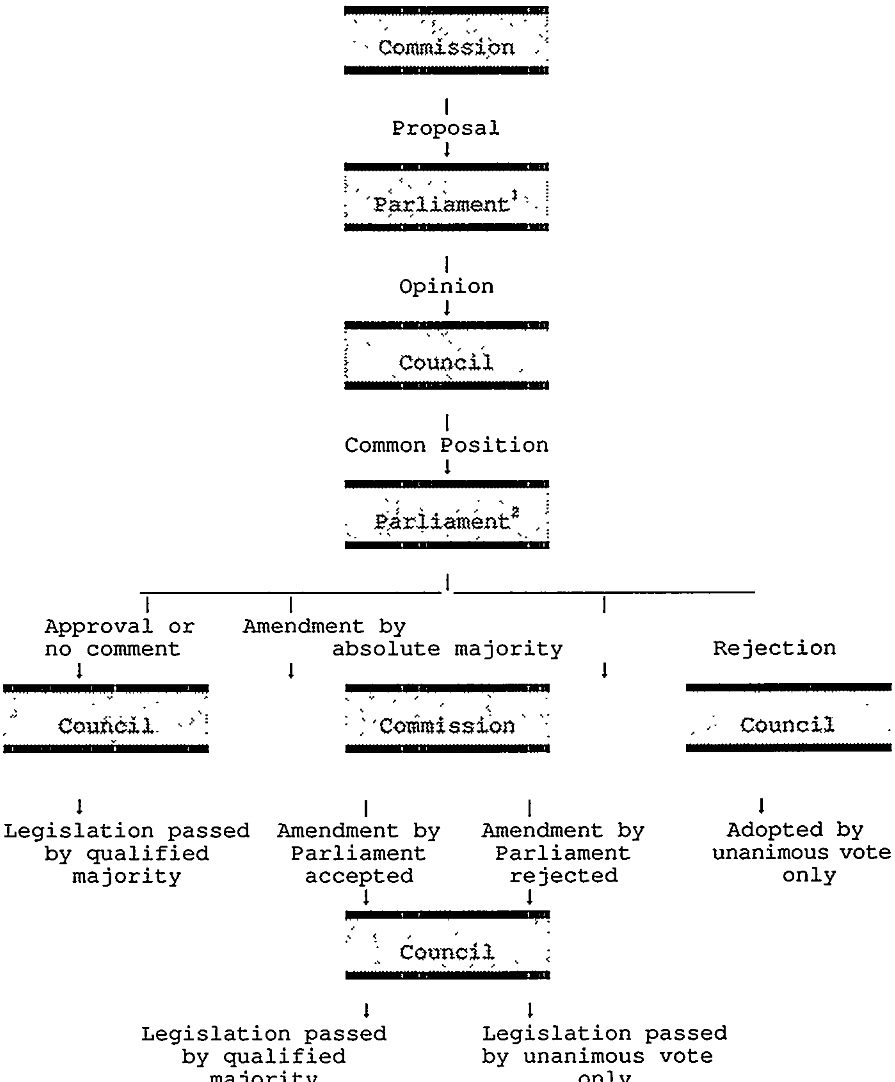
Commission proposal shall be deemed not to have been adopted.

(g) The periods referred to in points (b) and (f) may be extended by a maximum of one month by common accord between the Council and the European Parliament.

Id. art. 7.

The EC Delegation to the United States recently published the following chart illustrating the cooperation procedure:

The Interinstitutional Cooperation Procedure



[1]First Reading
[2]Second Reading

EC Delegation to the U.S., A Guide to the European Community 7 (1990).

of Ministers.[49] The Council in turn forwarded the First Proposal to the European Parliament[50] for an opinion (Parliamentary Opinion).[51] The European Parliament, on the basis of the Hoon Report[52] drawn up by its Committee on Legal Affairs and Citizens' Rights, proposed a number of substantive amendments which would have greatly strengthened the insider trading prohibition. Among the various amendments proposed in the Parliamentary Opinion were provisions adding "employees" to the class of restrained insiders,[53] increasing the scope of the directive to include off-market transactions,[54] providing a broad definition of nonpublic information,[55] requiring that competent authorities[56] be given investigatory powers,[57] demanding the harmonization of penalties,[58] and imposing civil remedies, including the indemnification of losses to private parties.[59] The

49. The Council has perhaps the most important role in the attainment of the objectives of the Treaty of Rome. The principal elements of that role are: (1) The responsibility to ensure the coordination of the economic policies of the Member States; (2) the power to make the final decision on all acts undertaken under the provisions of the Treaty of Rome, although most decisions require a prior proposal of the Commission and often consultation with the European Parliament and the Economic and Social Committee; and (3) the requirement that the Council confer certain powers on the Commission necessary for implementation of the Council's rules. Each Member State government delegates a representative in the Council, who must be a member of the government. The Council is governed by the Treaty of Rome, *supra* note 1, arts. 145-154. 3 Common Mkt. Rep. (CCH) ¶¶ 4402.01 -.07, 4406.03 (1989).

50. The people of the Member States directly elect their representatives to the European Parliament, which currently has 518 members. Unlike the traditional parliamentary function, the European Parliament has no legislative power; its main role is to give advisory opinions on the European Commission's proposed legislation. The European Parliament is governed by the Treaty of Rome, *supra* note 1, arts. 137-144. 3 Common Mkt. Rep. (CCH) ¶¶ 4302.01 -.07 (1989). *See generally* F. JACOBS & R. CORBETT, THE EUROPEAN PARLIAMENT (1990).

51. European Parliament Opinion on Proposal from the Commission to the Council for a Directive Coordinating Regulations on Insider Trading, 31 O.J. EUR. COMM. (No. C 187) 90 (1988) [hereinafter Parliamentary Opinion].

52. Committee on Legal Affairs and Citizens' Rights Proposed Amendment to the Proposal from the Commission of the European Communities to the Council for a Directive Coordinating Regulations on Insider Trading, EUR. PARL. SESS. DOCS., ser. A, Doc. A2-055/88 (May 5, 1988) [hereinafter Hoon Report].

53. Parliamentary Opinion, *supra* note 51, at 91.

54. *Id.*

55. *Id.* at 92.

56. *Id.* Article 8 of the Insider Trading Directive provides:

> 1. [Enforcement authorities to be designated] Each Member State shall designate the administrative authority or authorities competent, if necessary in collaboration with other authorities to ensure that the provisions adopted pursuant to this Directive are applied. It shall so inform the Commission which shall transmit that information to all Member States.
>
> 2. [Authorities to be given adequate powers] The competent authorities must be given all supervisory and investigatory powers that are necessary for the exercise of their functions, where appropriate in collaboration with other authorities.

Insider Trading Directive, *supra* note 3, art. 8.

57. Parliamentary Opinion, *supra* note 51, at 92.

58. *Id.*

59. *Id.* at 93.

only specific recommendation of the Hoon Report rejected by the European Parliament was that a violation of the directive's prohibition on insider trading would constitute both a breach of the criminal law and the basis for appropriate civil remedies in all member states.[60] The European Parliament, instead of prescribing the nature or severity of penalties, included in its opinion a mandate that the Commission advance proposals for harmonized penalties.[61] The European Parliament clearly believed that harmonization of rules, but not sanctions, would exalt form more than substance.

The European Parliament also suggested a significant change in the legal basis for the directive under the Treaty of Rome. The preamble to the First Proposal referred to Article 54(3)(g)[62] as the treaty basis for the directive.[63] This provision, in furtherance of the Treaty of Rome's "freedom of establishment,"[64] requires the Council to harmonize member state laws pertaining to the protection of investors in member state firms.[65] The Parliamentary Opinion recommended replacing Article 54(3)(g)[66] with Article 100a,[67] a provision added to the Treaty of Rome by the Single European Act in 1986.[68] Article 100a requires the Council to adopt harmonizing measures "which have as their object the establishment and functioning of the internal market."[69] Whereas Article 54(3)(g) is directed to harmonized standards of fair behavior toward *investors* and creditors of member state firms, Article 100a, as applied here, is directed to the establishment and smooth functioning of the EC's unified *securities markets*. One commentator, agreeing that Article 100a provides an appropriate legal basis for this and other securities law directives,[70] has suggested that the change in legal basis could have a significant influence on the future interpretation of the Insider Trading Directive.[71] The European Parliament's proposed modification of the directive's treaty basis was adopted by the Council and included in the preamble of the Insider Trading Directive.[72] Unfortunately, certain of the other proposed changes advanced by the European Parliament did not enjoy similar success.

The Commission, after considering the Parliamentary Opinion, submitted an amended proposal to the Council on October 4, 1988 (Amended

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60. Hoon Report, *supra* note 52, at 10.
61. Parliamentary Opinion, *supra* note 51, at 92.
62. Treaty of Rome, *supra* note 1, art. 54(3)(g).
63. First Proposal, *supra* note 14, preamble.
64. Treaty of Rome, *supra* note 1, art. 54(3)(g).
65. *Id.*
66. *Id.*
67. Parliamentary Opinion, *supra* note 51, at 90.
68. Single European Act, *supra* note 2, art. 18.
69. Treaty of Rome, *supra* note 1, art. 100a.
70. Fornasier, *The Directive on Insider Dealing*, 13 FORDHAM INT'L L.J. 149, 160 (1989-90).
71. *Id.* at 156.
72. Insider Trading Directive, *supra* note 3, preamble.

Proposal).[73] In the Amended Proposal, the Commission agreed to most of the changes recommended in the Parliamentary Opinion. Consequently, the prohibitory scheme became considerably stronger than that set forth in the First Proposal. The Commission failed, however, to accept and propose several of the European Parliament's more significant revisions. The Amended Proposal included part of the suggested broadening of the nonpublic information definition but did not include the criterion that information, to be characterized as public, must be *effectively disclosed* to the investing public.[74] The Commission, in a tragic misstep, failed to accept the parliamentary proposals pertaining to harmonization of penalties and civil remedies for violation of the directive.[75] Instead, the Commission, without any reference to criminal or civil remedies, added a requirement that the penalties required to be adopted by the member states must be "sufficiently dissuasive to ensure respect" for the insider trading laws enacted by the member states pursuant to the directive.[76] Moreover, the Commission added three new provisions in its Amended Proposal further diluting the scope of the directive. These included an exclusion from liability for *legal*, as opposed to *natural persons*,[77] an exemption for government securities,[78] and a restriction on a member state's application of the tipping prohibition to residents on the territory of the member state.[79] Thus, the Commission forwarded a watered down directive to the Council. The dilution would continue.

At this juncture in the legislative development of the directive, the financial services industry in the United Kingdom and elsewhere in the EC mobilized, finally convinced that the Commission would soon succeed in its effort to prohibit insider trading in the common market. During the roughly nine-month period between the Commission's presentation of the Amended Proposal and the Council's adoption of its "Common Position"[80] on July 17, 1989, numerous compromises were reached, virtually all of which weakened the regulatory force of the final product. The British, although not alone, virtually rewrote the directive to satisfy their objections. Vaingloriously, they even added their signature to the front page of the final version, changing the phrase, "insider trading," in the directive's title, to "insider dealing," the synonymous phrase in British legal terminology.[81]

73. Commission Amendment to the Proposal for a Council Directive Coordinating Regulations on Insider Trading, 31 O.J. EUR. COMM. (No. C 277) 13 (1988) [hereinafter Amended Proposal].

74. *Id.* art. 6.

75. Parliamentary Opinion, *supra* note 51, at 92-93.

76. Amended Proposal, *supra* note 73, art. 11.

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

78. *Id.* art. 1(4).

79. *Id.* art. 3(2).

80. Council Common Position Adopted with a View to the Adoption of a Council Directive Coordinating Regulations on Insider Dealing, EUR. PARL. SESS. DOCS., ser. C, Doc. C3-0018/89 (July 28, 1989) [hereinafter Common Position].

81. *Id. See supra* note 8. T

The compromises begin in the preamble with the addition of four paragraphs to reduce or eliminate liability for broker-dealers,[82] market makers,[83] analysts[84] and those complying with governmental requests for information.[85] The prohibition on primary and secondary insiders against taking advantage of inside information was qualified by an added requirement that the action be taken "with full knowledge of the facts."[86] The antitipping provision set forth in the Amended Proposal was narrowed to exclude tippees and other secondary insiders.[87] In defining "inside information," the "material effect on the price" criterion was deleted in favor of the phrase "significant effect on the price."[88] The mandate of cooperation among the member states' competent authorities was modified by providing several grounds for a member state's refusal to respond to official requests for information.[89] Finally, while penalties were left to the discretion of member states, the phrase, "shall be sufficiently dissuasive to ensure respect," was replaced by the less forceful phrase, "sufficient to promote compliance."[90] Although other substantive changes were made, including a comprehensive restructuring of the directive, these represent the more important revisions adopted by the Council. The Council then forwarded its Common Position to the European Parliament pursuant to the cooperation procedure.[91]

The European Parliament, in a last gasp effort, again sought to strengthen the directive. On October 11, 1989, it proposed two substantive amendments.[92] The first would have reimposed the directive's antitipping prohibition on secondary, as well as primary insiders.[93] The second proposal of

82. Common Position, *supra* note 80, preamble.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.* arts. 2(1), 4.

87. *Id.* art. 4. For the definitional distinction between primary and secondary insiders established by the Insider Trading Directive, see *infra* notes 180-196 and accompanying text.

88. Common Position, *supra* note 80, art. 1(1).

89. *Id.* art. 10(2). Article 10(2) of the Common Position provides that competent authorities "may refuse to act on a request for information": (a) where compliance "might adversely affect the sovereignty, security or public policy" of the requested member state, or (b) where the matter is being or has been prosecuted in the courts of the requested member state. *Id.* The final version of the directive, reflecting the Common Position, also provides for the "professional secrecy" of all information obtained by any competent authority, whether generated by its own efforts or obtained from the competent authorities of other member states. Insider Trading Directive, *supra* note 3, arts. 9 and 10(1). Moreover, absent the consent of the requested state, a requesting member state may use the information obtained from another member state only in connection with the insider trading investigation and not for other regulatory purposes. *Id.* art. 10(3).

90. *Id.* art. 13.

91. *See supra* note 48.

92. European Parliament Opinion on the Common Position of the Council with a View to the Adoption of a Directive Coordinating Regulations on Insider Dealing, 32 O.J. EUR. COMM. (No. C 291) 54 (1989) [hereinafter Second Parliamentary Opinion].

93. *Id.* at 54.

the European Parliament would have extended the applicability of a member state's trading and tipping prohibitions not only to "actions" occurring within its territory but also to its "residents" whose actions take place elsewhere.[94] Both changes were rejected by the Council, which adopted the directive without further discussion on November 13, 1989.[95] The Council, in the penultimate article of the directive, gave the member states a June 1, 1992 deadline to enact national legislation in conformity with its prohibitions.[96]

The tortuous legislative development of the directive, which will be refined further in the ensuing analysis of the directive's prohibitions, is crucial to any comprehensive understanding of the directive's scope and effect. Because of the wide margin of discretion given to the member states, as well as the Council's ambivalent position both on the criminality of the prohibited conduct and the penalties to be imposed, the new European sin may be transformed into twelve moral fragments, indeterminate and disharmonious.

III. The Doctrinal Basis for the Directive

The Insider Trading Directive imposes three substantive rules: A prohibition against trading applicable to both primary insiders[97] and secondary insiders;[98] a prohibition on tipping applicable to primary insiders, but not

94. The First Proposal's trading rule provided that when a prohibited transaction is executed on a stock exchange market, the directive-based insider trading laws of the member state where that stock exchange is located are applicable. First Proposal, *supra* note 14, art. 1. When not executed on an exchange market, laws of the member state where the non-insider opposite trader is a resident are applicable. *Id.* The First Proposal's tipping rule provided for applicability of the law of the member state where the insider is a resident. *Id.* art. 2. These territorial scope provisions were harshly criticized by the British as too restrictive. *See, e.g.*, The Law Society's Standing Committee on Company Law, Memorandum on the Proposal for a Directive Coordinating Regulations on Insider Trading 4-7 (1987). The Insider Trading Directive looks to the place where the wrongful actions occurred rather than to the place of the wrongdoer's domicile.

The directive, as adopted, provides as follows:

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

Insider Trading Directive, *supra* note 3, art. 5.

The Council, in adopting this language, rejected the suggestion made by the European Parliament that a member state's trading and tipping rules also be extended to its residents regardless of where the actions take place. Although each member state may extend the application of its law to residents, the directive does not require that extension.

95. Insider Trading Directive, *supra* note 3.

96. *Id.* art. 14.

97. *Id.* art. 2.

98. *Id.* art. 4. *See infra* notes 180-196 and accompanying text.

to tippees and other secondary insiders;[99] and a mandatory current disclosure requirement applicable to firms whose securities are publicly traded in any regulated market.[100] Each of these rules finds its source in the EC's philosophy of disclosure in the regulation of the securities markets of the member states.[101] This regulatory philosophy has been amply demonstrated in both the corporate and securities law directives previously adopted.[102] The Commission's doctrinal foundation for the EC's insider trading rules is outlined in the recitals to the directive.[103] A synthesis of those recitals reveals two fundamental objectives: Enhanced *harmonization* and *improved market function*.

Harmonization, of course, is the basic game plan of the EC's 1992 program under the Treaty of Rome. The Treaty basis for the directive, Article 100a, mandates "approximation" of member states' laws,[104] and the recitals in the directive repeatedly refer to the necessity of "coordinated rules" among the member states.[105] Harmonization, by definition, is intended to reduce inconsistencies among the various regulatory schemes that enable abusive behavior. The harmonization sought through the Insider Trading Directive actually serves not only to develop a degree of regulatory parity, but also to "level up" pre-existing national regulatory schemes to the directive's common denominator.[106] For three-fourths of the member states, harmonization meant the regulation of conduct to which governmental authorities had remained indifferent. In this context, harmonization truly legislates. Under the directive's command, harmonization becomes a backhoe, leveling the regulatory fields of the member states and leveling the playing fields for EC investors. When the leveling is done, the recitals claim, the function of the securities markets will be enhanced.

The improved market function objective is certainly more directly critical to the directive's substantive prohibitions than the harmonization objective. After all, the EC Commission could have harmonized to a common denominator considerably less comprehensive than the directive and much closer to the pre-existing regulatory vacuum found in most of the member states.

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99. Insider Trading Directive, *supra* note 3, art. 3.

100. *Id.* art. 7. It should be noted that application of the Insider Trading Directive's current disclosure rule, as a result of its reference to Article 1(2), is not expressly limited to issuers with securities listed on the exchanges of the member states, while, under Article 5, the trading and tipping rules are limited to transactions on a market situated in a member state's territory. *See supra* note 94. Given the directive's policy focus on the improved function of the EC's securities markets, member states are likely to limit application of their current disclosure rules to issuers domiciled inside or outside the common market that have securities listed on markets located solely in the member states. *See infra* notes 130-135 and accompanying text.

101. *See* Warren, *supra* note 25, at 209. *See also* Cruickshank, *supra* note 40, at 347.

102. *See supra* notes 26-35 and accompanying text.]

103. Insider Trading Directive, *supra* note 3, preamble.

104. Treaty of Rome, *supra* note 1, art. 100a.

105. Insider Trading Directive, *supra* note 3, preamble.

106. *See* Warren, *Euroequity Offerings*, *supra* note 10, at 24.

A quantitative deconstruction of the directive's recitals finds two normative references to the equality of opportunity, or fair play value, three references to investor confidence and five references to improved market function.[107] These references attempt, collectively, to establish a linkage between investors being placed on an "equal footing" *vis a vis* other investors[108] (fair play),[109] the enhancement of investors' confidence in the EC's securities markets,[110] and the positive impact of that confidence, presumably contributing to increased market depth and liquidity, on the "smooth functioning" or efficiency of those securities markets.[111] Consequently, the policy argument runs, the two mandates of Article 100a, the harmonization of national laws and the establishment and functioning of the internal market, will be fulfilled. Although this linkage might be viewed as feeble casuistry, it provides a useful guide to the intent and purposes of the directive.

The linkage between fair play, enhanced confidence, and improved market function does not appear to have been intensely analyzed by the drafters of the directive. Apparently, the linkage was intuitively self-evident to the Commission. In its explanatory memorandum accompanying the First Proposal, the Commission makes no reference to any anecdotal or empirical data supporting its assumptions.[112] Neither the literature written thus far nor interviews by the author with various parties involved in the drafting of the directive indicate any consideration by the Commission of the intense theoretical debate among academics and others regarding the value of insider trading regulation.[113] Obviously, "free market" arguments that insider trading is a victimless crime,[114] or a beneficial incentive compensation scheme for risk-averse management,[115] or an important contributor to more efficient

107. Insider Trading Directive, *supra* note 3, preamble.

108. *Id.*

109. *See* Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 805-09 (1980).

110. Insider Trading Directive, *supra* note 3, preamble.

111. *Id.*

112. *First Proposal, supra* note 14, explanatory memorandum.

113. The relative merits of insider trading regulation have been the subject of intense debate in the United States. *See infra* notes 114-119 and accompanying text. That debate has focused extensively on the improved market function rationale that guided the EC in formulating the Insider Trading Directive under the Treaty of Rome. Commonly referred to as the "integrity of the market theory," this policy favoring regulation has been summarized as follows:

> The primary policy reason for proscribing trading while in possession of material nonpublic information is to make investors confident that they can trade securities without being subject to informational disadvantages. The goal is to guarantee the integrity of the market.

Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985).

114. *See, e.g.*, Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863, 890-91 (1987).

115. *See, e.g.*, H. MANNE, INSIDER TRADING AND THE STOCK MARKET 138-43 (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861-66 (1983).

pricing of securities,[116] held little sway for the Commission. Conversely, no consideration appears to have been given to the rejoinder that insider trading is a misappropriation of property rights,[117] or a self-determined random compensation package with high monitoring costs,[118] or, most importantly, an inducement to the moral hazard of selective disclosure and disinformation schemes.[119] The Commission, in effect, has agreed with the conclusion of the American Bar Association study that "a widespread fear of pervasive unfairness to investors [has] a potentially corrosive impact on the securities markets."[120] Perhaps, in reaching its conclusion, the EC had become cognizant of the "potentially corrosive impact" on politicians that accompanied several highly publicized insider trading scandals in Great Britain and France.[121] What may have mattered to the EC drafters, as aptly stated by an *Economist* essay, "is the gut instincts of millions of ordinary people whose savings fuel the markets and whose votes can turf out of office politicians who favour free markets" and oppose regulation.[122] Whether the various member states' legislatures and enforcement authorities concur with the EC conclusion remains to be seen, especially given their regulatory and business traditions.

The daisy chain of linear conclusions supporting the market function objective, while admittedly simplistic, deserves a closer look. The switch in treaty basis from Article 54(3)(g) to Article 100a of the Treaty of Rome[123] establishes a well-spring for interpreting the intent and, hence, the contours of the directive's prohibitions. Article 54(3)(g) is oriented to the open-ended morass of investor protection and to various notions of fraud and fiduciary obligations imposed on corporate management.[124] Article 100a, however, is

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116. *See, e.g.*, MANNE, *supra* note 115, at 78-104; Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities Exchange Commission*, 13 HOFSTRA L. REV. 127, 133 (1984). *But see* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 629-34 (1984).

117. *See, e.g.*, Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 39-47 (1984).

118. *See, e.g.*, Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332.

119. *See, e.g.*, Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L. J. 628, 636-37, 643; Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of Large Corporations*, 80 MICH. L. REV. 1051, 1051-1064 (1982); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448-50 (1967); Scott, *supra* note 109 at 815-816; Seligman, *supra* note 113, at 1095; Warren, *A Foreword on Insider Trading Regulation*, 39 ALA. L. REV. 337, 346-47 (1988).

120. ABA Comm. on Fed. Regulation of Sec., *Report on the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 225 (1985).

121. *See supra* note 19.

122. *Insider Trading*, ECONOMIST, Nov. 22, 1986, at 15.

123. *See supra* notes 62-72 and accompanying text.

124. Treaty of Rome, *supra* note 1, art. 54(3)(g). Article 54(3)(g) provides:

3. The Council and the Commission shall carry out the duties devolving upon them

oriented not to the breach of duties by management or individual market participants, but rather to the overall efficiency of the marketplace.[125] While not contradictory to and, indeed, supportive of investor protection concerns, this approach avoids the plague of difficulties that has devastated insider trading jurisprudence in the United States.[126] Freed from the restraints of

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under the preceding provisions, in particular:

g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community.

125. *Id.* art. 100a. Article 100a states:

By way of derogation from Article 100 and save where otherwise provided in this Treaty, the following provisions shall apply for the achievement of the objectives set out in Article 8a. The Council shall, acting by a qualified majority on a proposal from the Commission in cooperation with the European Parliament and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.

126. It is beyond the scope of this article to explain in depth the failure of insider trading jurisprudence in the United States. In large measure, the failure is due to the absence of any specific rule of law defining insider trading. *See infra* note 141 and accompanying text. The SEC, instead of seeking a statutory or regulatory prohibition, decided to build the insider trading "house of cards" on rule 10b-5, 17 C.F.R. § 240.10b-5 (1990), a broad, nonspecific antifraud rule "virtually as vague as the Due Process Clause." L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 728 (2d ed. 1988). Taking a rather creative view, the SEC fashioned from rule 10b-5 an affirmative duty to disclose nonpublic information before trading the securities to which that information relates. In re Cady, Roberts & Co., 40 S.E.C. 907 (1961). Although followed by the Second Circuit in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), the affirmative disclosure duty created by the SEC did not survive Supreme Court scrutiny. In Chiarella v. United States, 445 U.S. 222 (1980), the Court turned to state law notions of fiduciary duty to determine whether some element of deception or manipulation might be present to justify invoking rule 10b-5. Because the trader had no fiduciary duty to disclose the nonpublic information to shareholders of the corporation whose securities he traded, rule 10b-5 could not be applied. *See generally* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1 (1982). Similarly, in Dirks v. SEC, 463 U.S. 646 (1983), the Supreme Court extended its fraud-fiduciary duty analysis to a tippee, requiring a breach of duty by the insider divulging the information as a prerequisite to the "derivative duty" of the tippee. To circumvent the Court's restrictive, but understandable, view of rule 10b-5, the SEC promulgated rule 14e-3, 17 C.F.R. § 240.14e-3 (1990), to prohibit insider trading in connection with takeovers. The SEC's authority to do so has been seriously challenged by the Second Circuit in United States v. Chestman, 903 F.2d 75 (2d Cir. 1990), now awaiting an *en banc* decision. *See* Lambert, *Court to Review Insider-Trade Case that was Reversed*, Wall St. J., Aug. 28, 1990, at B4, col. 3. In other cases, the SEC has resorted to the so-called "misappropriation theory," which holds that a trader who steals nonpublic information or obtains it through a breach of duty under tort or contract law is subject to prosecution under rule 10b-5. In United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987), the Supreme Court sidestepped the SEC's misappropriation theory as adopted by the Second Circuit. No one knows where rule 10b-5 will take us next in the SEC's struggle with insider trading and the vagaries of fraud-related duties to disclose. *See generally*, Warren, *Who's Suing Who? A Commentary on Investment Bankers and the Misappropriation Theory*, 46 MD. L. REV. 1222 (1987).

vague fiduciary duty and fraud concepts, the directive's daisy chain becomes curvilinear, with Article 100a as its clasp, closing the circle around the unified securities market as a whole, without any need to address the injuries to individual investors or firms resulting from fraud or other tortious conduct. Thus, through its prohibitions, the directive is able to circumvent tedious distinctions between insiders and outsiders, inside information and market information, the immoral tipper and the derivative tippee, all based on the fraud and fiduciary duty rubric which led to the collapse of the United States Securities and Exchange Commission's (SEC) Rule 10b-5[127] as applied to insider trading of securities.[128] By eliminating the forced use of criteria underlying fraud, deception and related fiduciary duty notions,[129] the EC has produced a directive which has greater potential effectiveness on its face than the evolving insider trading prohibitions in the United States. The market function objective, as the primary basis underlying the EC's insider trading directive, should prove a beneficial guide to the interpretation of the directive's substantive rules.

IV. The Elements of the Trading and Tipping Rules

Any comprehensive understanding of the three substantive rules imposed by the EC's Insider Trading Directive obviously is dependent on a thoughtful analysis of their respective elements. Of the three rules, the current disclosure rule,[130] which simply expands the scope of application under the EC's Admission Directive, is the least far-reaching. The EC's Admission Directive,[131] adopted in 1979, established a timely disclosure duty not for insiders, but for the *issuers* of all securities listed on the stock exchanges of the member states. The Admission Directive imposed a continuing obligation on all companies with shares officially listed on any member state's stock exchange to

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127. 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 provides:

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

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

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the state made, in the light of the circumstances under which they were made, not misleading, or

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

128. *See supra* note 126.

129. Other commentators agree that the directive's prohibitions are solely statutory and, consequently, operate free from the constraints of the law of torts. *See, e.g.*, Hopt, *supra* note 47, at 64; Note, *Toward Unification*, *supra* note 8, at 450; Note, *Securities—Insider Trading—The Effects of the New EEC Draft Insider Trading Directive*, 18 GA. J. INT'L & COMP. L. 119, 134-35 (1988); Note, *A Comparative Analysis*, *supra* note 3, at 240-41.

130. Insider Trading Directive, *supra* note 3, art. 7.

131. *Supra* note 31.

> inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares.[132]

The Insider Trading Directive's current disclosure rule extends this obligation to all companies whose securities are admitted to trading on any regulated market, wherever located.[133] The current disclosure rule is subject to the Admission Directive's escape hatch, which permits companies to seek a disclosure exemption from competent authorities where that disclosure would prejudice the company's "legitimate interests."[134]

The directive's current disclosure rule does not work a major change in the existing laws of the member states and, consequently, has not been particularly controversial.[135] The two other rules, the prohibitions against insider trading and tipping, are intended to accomplish radical change for most of the member states. These prohibitions are the core rules of the Insider Trading Directive and represent the genesis of the EC's supranational insider trading regime.

The insider trading rule prohibits an insider, one who possesses "inside information," "from taking advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates."[136] The trading rule incorporates four elements: (1) Possession of inside information, (2) by an insider, (3) who takes advantage of that information by trading, (4) while having full knowledge of the facts. The directive distinguishes two categories of insiders: *Primary insiders* and *secondary insiders.* Primary insiders are persons who possess inside information as a consequence of their employment or other direct positional access to that information.[137] Secondary insiders are persons other than primary insiders who possess inside information, "the direct or indirect source of which could not be other than a [primary insider]."[138] The trading rule applies to both categories of insiders, but the tipping rule does not.

The directive's tipping rule prohibits *primary insiders* from "disclosing . . . inside information to any third party unless such disclosure is made in the normal course of the exercise of his employment, profession or duties."[139] In addition, the tipping rule prohibits *primary insiders* from "rec-

132. Admission Directive, *supra* note 31, schedule C(5)(a).
133. Insider Trading Directive, *supra* note 3, art. 7. *See supra* note 100.
134. Admission Directive, *supra* note 31, schedule C(5)(a).
135. *See, e.g.*, Note, *A New Look*, *supra* note 3, at 150.
136. Insider Trading Directive, *supra* note 3, art. 2(1).
137. *Id.*
138. *Id.* art. 4.
139. *Id.* art. 3(a).

ommending or procuring a third party, on the basis of that inside information, to acquire or dispose of transferable securities."[140] Although the tipping rule does not apply to *secondary insiders*, the trading and tipping prohibitions both depend on the possession of "inside information" by "insiders" and, thus share certain common elements. After an analysis of the four common elements of the trading rule, two of which are shared with the tipping rule, the article will address the additional elements of the trading rule as applied to secondary insiders and of the tipping rule applicable only to primary insiders.

A. *Inside Information*

The directive commences its development of the prohibitions by use of a technique that the SEC has avoided both to its peril and to the peril of investors generally:[141] The use of a statutory definition of the key concept, "inside information."[142] The EC defines the term as having four essential characteristics:

(1) information which has not been made public (*nonpublic*);
(2) of a precise nature (*precise*);
(3) relating to one or several issuers of transferable securities[143] or to one or several transferable securities (*market information*);
(4) which, if it were made public, would be likely to have a significant effect on the price of the securities (*price sensitive*).[144]

Each of these characteristics is the product of compromise during the drafting process and should be separately addressed in order to appreciate the EC's concept of inside information.

1. Nonpublic Information

The first of these characteristics of inside information, "information which has not been made public," forms an integral part of the directive's

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140. *Id.* art. 3(b).

141. The SEC has consistently refused to seek a statutory or regulatory definition of inside information. *See Symposium: Defining Insider Trading*, 39 Ala. L. Rev. 337-558 (1988). *See generally* Ricks, *GAO Concludes Insider Trading Needs Definition*, Wall St. J., Sept. 26, 1988, at 37, col. 1.

142. Insider Trading Directive, *supra* note 3, art. 1(1).

143. The term "transferable securities" is defined in article 1(2) as:

(a) shares and debt securities, as well as securities equivalent to shares and debt securities;
(b) contracts or rights to subscribe for, acquire or dispose of securities referred to in (a);
(c) future contracts, options and financial futures in respect of securities referred to in (a);
(d) index contracts in respect of securities referred to in (a);

when admitted to trading on a market which is regulated and supervised by authorities recognized by public bodies, operates regularly and is accessible directly or indirectly to the public.

144. Insider Trading Directive, *supra* note 3, art. 1(1).

goal to put investors on an "equal footing."[145] In aiming for a reduction of trading benefits for those who profit from informational asymmetries, the directive works a revival of the SEC's "parity of information" approach.[146] That approach, which was the predicate for the *In re Cady, Roberts & Co.*[147] "disclose or abstain" from trading rule, was rejected by the United States Supreme Court in *Chiarella v. United States.*[148] Although the *Chiarella* Court entangled itself in the duty to disclose analysis arising from fraud and related fiduciary duty theories, the EC, as noted previously, has avoided this analytical trap in fashioning its own insider trading rules. The SEC's old "disclose or abstain" rule conceivably could enjoy a renaissance in the common market. The coverage of the rule, of course, depends to a great extent on how restrictively the phrase "has not been made public" is interpreted.

The directive itself provides little guidance in determining the breadth of the phrase. The European Parliament accepted the Hoon Report recommendation that the phrase be changed to information "inaccessible or not available to the public"[149] and that this language be amplified by a provision stating that publication necessarily involves "the effective disclosure of inside information in such a manner sufficient to ensure its availability to the investing public."[150] These revisions, ultimately rejected by the Council, would have established more clearly a higher standard of dissemination, including a waiting period sufficient in length to permit the financial press' or other media's publication of the information.[151] This "effective

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145. *Id.* preamble.

146. The "parity of information" theory rests on the assumption that the federal securities laws were designed to ensure that all investors have equal access to the information needed for rational investment decisions. The SEC, in In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), applied the theory to develop under rule 10b-5, 17 C.F.R. § 240.10b-5 (1990), an affirmative duty to disclose any material nonpublic information prior to trading or to abstain from trading the subject securities.

147. 40 S.E.C. 907 (1961).

148. 445 U.S. 222 (1980). In *Chiarella,* the Supreme Court refused to send a financial printer to jail on a proven charge that he used confidential information provided by his firm's clients to reap trading profits, a clear violation of the *Cady, Roberts* "disclose or abstain" rule. Instead, the Court imposed the requirement that state law must provide the foundation of any duty to disclose under rule 10b-5. *Id.* at 230; *see supra* note 126.

149. Parliamentary Opinion, *supra* note 51, at 92.

150. *Id.* The remarkable similarity of the Hoon Report's phrase to that used in one of the seminal cases in American insider trading jurisprudence suggests that the language was borrowed. In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969), the Second Circuit stated: "Before insiders may act upon material information, such information must have been *effectively disclosed in a manner sufficient to insure its availability to the investing public*" (emphasis added). "Otherwise," the court explained, "insiders would be able to beat the news . . . by requesting in advance that their orders be expected immediately after the dissemination of a major news release but before outsiders could act on the release." *Id.* at 853.

151. *See generally* L. Loss, *supra* note 126, at 749 n.79; 6 L. Loss, Securities Regulation 3605-09 (2d ed. 1961).

dissemination" interpretation, already suggested by one expert,[152] would serve to deny an insider the benefits of the brief window of opportunity immediately following disclosure and prior to active trading in the subject securities. Another commentator has expressed the view that the nonpublic characteristic under the directive be defined by reference to the efficient capital market hypothesis.[153] Under such a definition, significant trading by investors must occur to "inform" the market prior to the insider's trades, thereby disadvantaging the insider, who must delay his trades until the subject information "corrects" the preexisting price.[154] The legislative history of the directive reveals no consideration by the drafters of this particular definitional approach. Despite the Council's rejection of the specific language suggested by the European Parliament, the directive's phrase, "not been made public," must embrace the effective dissemination concept and certainly should not be interpreted to condone an insider's electronic footrace to the market before the financial presses roll.

2. Precision

The second characteristic, that the information be of "a precise nature," was borrowed from France's insider trading jurisprudence, which requires that the information be "precise, special and certain."[155] French courts have held that this restriction would exclude information consisting solely of rumors[156] but would include information regarding business negotiations when those negotiations were likely to result in a completed transaction.[157] The Commission explained that the phrase in its First Proposal, "unknown to the public of a specific nature,"[158] meant that "a simple rumor cannot therefore be regarded as inside information."[159] The requirement of "precision" is foreign to United States securities laws, which require a factual analysis under the "materiality" element of the SEC's Rule 10b-5.[160] The directive's definition of inside information does not refer to "materiality" but refers instead to the precision and price sensitivity characteristics. One might argue that these two combine to establish a "materiality" element similar to that applied under the United States securities laws. However, as noted in the subsequent discussion of the price sensitivity characteristic, the directive's phrase "significant effect on the price," appears to be more restrictive in scope than the "materiality" element under United States law. The directive's term, "of a precise nature," to be accorded any value, must

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152. Hopt, *supra* note 47, at 58.

153. *See*, Note, *A Comparative Analysis*, *supra* note 3, at 251; *see generally* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

154. *See supra* note 116 and accompanying text.

155. Judgment of 26 May 1977, Cour d'appel, Paris, 1978 J.C.P. II No. 18789 (1st case).

156. *Id.*

157. Judgment of 18 Apr. 1979, Trib. gr. inst., Fr., 1980 J.C.P. II No. 19306 (2nd case).

158. First Proposal, *supra* note 14, art. 6.

159. *Id.* explanatory memorandum.

160. *See infra* notes 171-173 and accompanying text.

serve as a further restriction on the types of information covered by the directive. Accordingly, one must deal with the rather troublesome conclusion that the combined effect of the precision and price sensitivity characteristics may substantially reduce the scope of the inside information to be regulated under the directive.

3. Market Information

The third characteristic, in referring to one or more issuers or to one or more securities, is intended to establish the directive's coverage of broad informational categories traditionally characterized as "inside information" and "outside" or "market information." The term "inside information" commonly includes information normally known only to management or its agents and pertaining to the assets, earnings or securities of that management's corporate employer.[161] The term "market information" generally refers to information concerning events or circumstances which affect the market for a corporation's securities but which do not necessarily relate to that corporation's assets or earnings.[162] The Insider Trading Directive, in contrast to American law, eliminates the distinction between the two categories of information by combining them in its definition.

The sources of information relating to the market price of a corporation's securities include traditional insiders, such as the corporation's directors, officers and support personnel, and a wide range of outsiders, such as suppliers and creditors, lawyers, accountants, investment bankers, broker-dealers, journalists and governmental officials. Market information, unlike classic inside information, is source neutral. Moreover, market information, unlike inside information, includes all information relating to the market price of a corporation's securities, whether generated by insiders or outsiders, whether economic or political. The information may be "hard" data reflecting the subject corporation's past economic performance or "soft" data reflecting either its own or another firm's projections as to the corporation's future economic performance. Because the directive links the information to "one or several" issuers or securities, the covered information may relate not directly to a particular corporation but to an entire industry or, for that matter, to the entire economy. Indeed, one writer has observed that even the death of a president might fall within the directive's definition of inside information.[163] The Commission explained the extraordinary scope of this characteristic:

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161. Generally, the term "inside information" refers to "information which comes from within the corporation or affects the price of corporate stock because of its reflection of a corporation's expected earnings or assets." Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 329 (1979).

162. The term "market information" has been defined as "information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power." Fleisher, Mudheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973). *See also* Karmel, *Market Information: Insider Trading*, 195 N.Y.L.J. 1 (1986).

163. Hopt, *supra* note 47, at 59.

> [T]his condition . . . covers information concerning an issuer, whether originating from within the issuer (for example, an increase in profits) or outside it (for example, a bid to take it over launched by another company). It also covers information on the situation or prospects of one or more securities and information which is likely to influence the market as such (for example, the decision of a central bank to alter the discount rate).[164]

The directive, by broadly defining market information to subsume traditional inside information, has combined the inside and market information categories. The relating of the directive to one or more issuers and one or more securities is both innovative and far-reaching.

The EC's refusal to make a distinction between inside and market information is clearly consistent with its doctrinal basis for the directive, which is oriented toward market function rather than corporate behavior. In effect, at least with respect to this characteristic, all sources and all types of information are covered; therefore, the proviso becomes unnecessary in the sense that it does not impose any restriction or expansion on the term "information." Inclusion of the proviso, however, does serve to clarify the broad scope of the directive's trading and tipping prohibitions and certainly negates any restrictive inference from the directive's use of the term "inside information." The EC's decision to address the infinitely broader category of market information, as originally recommended by the Commission in its European Code of Conduct,[165] underscores the vehemence of the EC in its condemnation of insider trading as an abuse of the developing unified marketplace. This characteristic contributes enormously to the vitality of the directive.

4. Price Sensitivity

The last of the characteristics defining the term "inside information" is the requirement that the information, "if it were made public, would be likely to have a significant effect on the price" of the securities.[166] This characteristic is borrowed from the British Company Securities (Insider Dealing) Act 1985.[167] In the First Proposal the Commission used the phrase "material effect,"[168] but this phrase was subsequently deleted by the Council without explanation in favor of the phrase "significant effect."[169] The Commission envisaged this characteristic as a critical limitation on its definition. The Commission explained:

> All information unknown to the public is not therefore necessarily inside information. If such were the case, the managers or directors

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164. First Proposal, *supra* note 14, explanatory memorandum.
165. European Code of Conduct, *supra* note 38, at 42.
166. Insider Trading Directive, *supra* note 3, art. 1(1).
167. *See supra* note 8.
168. First Proposal, *supra* note 14, art. 6.
169. Insider Trading Directive, *supra* note 3, art. 1(1).

> or even most of the employees of a company would never be able to carry out transactions in the securities of their companies, since they always have information which has not been published.[170]

This sensitivity differs considerably from the "materiality" concept that forms a basic tenet of American securities law.[171] As defined by the United States Supreme Court in *TSC Industries v. Northway*,[172] a material fact is one that would have had a substantial likelihood of assuming actual significance in the investment decision of a reasonable investor or, alternatively, of being viewed by that investor as having significantly altered the total mix of available information.[173] "Materiality" focuses on an *individual's* decision whether to invest; "price sensitivity" focuses, instead, on the likely impact of the information on the *market's* overall pricing of the shares.

The directive, consistent with its market function objective, is only indirectly concerned about any particular investor. A particular investor, seeking diversification of his portfolio, might attach considerable significance to data concerning a company's product or geographical market segments. This information, if fully disclosed, might have only a minimal effect, if any, on the short-term price of that company's securities. Market price, of course, reflects not so much one investor's transaction but the composite of all investors' decisions. While virtually all price sensitive facts under the directive presumably would be "material," not all "material facts" are necessarily "price sensitive." "Price sensitivity," therefore, is significantly more restrictive than "materiality" in defining "inside information." Given the expansive scope of the directive in combining inside and market information, however, the price sensitivity characteristic can hardly be viewed as a fatal flaw.

5. Definitional Limitations

During the deliberations on the First and Amended Proposals, the breadth of the initial definition of inside information created a furor in the British financial services industry.[174] Securities professionals expressed concern that company reports produced by their research analysts might be considered inside information and, thus, would preclude those with knowledge of those reports, especially customers, from trading in the securities to which those reports relate. Others advanced the argument that the knowledge possessed by a prospective bidder regarding his own decision to

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170. First Proposal, *supra* note 14, explanatory memorandum.

171. *See supra* text accompanying note 160.

172. 426 U.S. 438 (1976).

173. TSC Indus. v. Northway, 426 US. 438, 438 (1976); *see also* Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

174. *See, e.g., Ensuring the 1992 Programme Isn't a Spivs' Charter; The European Market*, Fin. Times, June 19, 1989, at 2, col. 1; Dickson, *EC to Have Common Rules Against Insider Dealing*, Fin. Times, June 16, 1989, at 12, col. 1; Cohen, Fidler & Dickson, *City Anger at EC Insider Proposals*, Fin. Times, May 12, 1989, at 24, col. 1.

acquire securities of a target company would be, under a literal interpretation of the directive, price-sensitive, nonpublic, precise, market information, which would preclude the bidder from commencing the acquisition without first informing the market.[175] Broker-dealers and investment bankers expressed their fears that the knowledge inherent in their normal course of trading activities would result in severe curtailment of their business.[176] Rather than tinker with its definition of inside information, at the time the Council adopted the Common Position it added three recitals to the directive's preamble to alleviate these concerns. The first states that a prior decision to buy or sell securities does not, in itself, constitute inside information that would preclude the decision maker from executing a buy or sell decision.[177] This is followed by a recital that activities by market-makers, *countreparties* and stockbrokers with inside information who confine themselves to the pursuit of their normal business of buying or selling securities, of executing customer orders, or of engaging in price stabilization in connection with public offerings, would not, absent other circumstances, constitute the use of inside information.[178] The last recital states that estimates developed from publicly available data are not to be regarded as inside information.[179] The addition of these recitals was obviously expedient in placating the opposition.

B. Insiders

The definition of inside information is common to both the prohibition on insider trading and the prohibition on tipping. Obviously, one must possess inside information, as that term is defined, before one can take advantage of or tip the information to others. Instead of applying the prohibitions to all those who trade or tip, the directive establishes duties which sequestrate possessors of inside information into two camps: Primary insiders and secondary insiders.[180] Primary insiders are, in essence, those who come into possession of inside information by virtue of their management position,[181] their equity position as shareholders,[182] or as a result of access to the information by virtue of the exercise of their employment, profession or duties.[183] Secondary insiders are those persons who do not have such positional access to inside information but who nevertheless come into possession of information which must have as its source, directly or

175. *See* sources cited *supra* note 174.

176. *See* sources cited *supra* note 174.

177. Insider Trading Directive, *supra* note 3, preamble.

178. *Id.*

179. *Id.*

180. Insider Trading Directive, *supra* note 3, arts. 2,4. *See supra* notes 137-138 and accompanying text.

181. Insider Trading Directive, *supra* note 3, art. 2(1).

182. *Id.*

183. *Id.*

indirectly, primary insiders.[184] This group presumably includes both the intended and unintended beneficiaries of inside information.

While the inside information concept, as previously stated, is source neutral, the primary and secondary insider concepts are not. To be a primary insider, the source must derive, directly or indirectly, from status or position. To be a secondary insider, the source must derive from a primary insider. Under the SEC's decision in *Cady, Roberts & Co.*,[185] this would work a distinction without a difference. Under the First Proposal, this was also the case because the trading and tipping rules applied to both categories of insiders.[186] However, the Council's first amendments provided the difference, rendering the distinction critical. Primary insiders are prohibited from trading or tipping inside information. Secondary insiders are only denied the right to trade. They may tip as they please, although their trading tippees may be liable under the trading rule. Consequently, in a given case one must explore those categories further in order to comprehend the bifurcation of these prohibitions. One must be careful, of course, not to draw these distinctions from insider trading jurisprudence in the United States, where positional access remains critical to liability standards based on a tortious or contractual breach of duty to a third party. Similar to the EC's *inside* information "misnomer," which incorporates inside and outside information, the directive's view of primary insiders includes classic insiders,[187] constructive insiders,[188] and all outsiders who come into possession of the information by virtue of their status or position. This results from the directive's catch-all provision covering persons possessing inside information through access by virtue of the exercise of their "employment, profession or duties."[189] One writer has concluded that this clause nets all employees, regardless of whether their access is regular or occasional, professional insiders such as accountants and attorneys, and true outsiders such as stock exchange employees, government officials, creditors and suppliers, union leaders, journalists and even legislators.[190] Again, their *direct access* to inside information by virtue of status or position is the sole criterion. All others possessing inside information, from the primary insider's sister-in-law to taxi drivers, are secondary insiders. Given the breadth of the phrase, "employment, profession or duties," in marking the primary insiders, the secondary insiders category is notably more restrictive.

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184. *Id.* art. 4.

185. 40 S.E.C. 907 (1961).

186. First Proposal, *supra* note 14, art. 3. Unlike the directive in its final form, the First Proposal imposed the tipping prohibition not only upon primary insiders but upon secondary insiders as well.

187. *See supra* note 181.

188. The term "constructive insiders" has been applied to a category of corporate agents, including underwriters, accountants, lawyers, consultants and other outsiders, who as a result of their special relationship with the corporate entity may be deemed fiduciaries of the corporate shareholders. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

189. Insider Trading Directive, *supra* note 3, art. 2(1).

190. Hopt, *supra* note 47, at 63-64.

The distinction between primary and secondary insiders and the breadth of their respective definitions begs the question, "Who is left?" If the primary insider category includes everyone from the Texas Gulf Sulphur officers[191] to Vincent Chiarella of Pandick Press[192] and Foster Winans[193] of the *Wall Street Journal*, and if the secondary insider category includes everyone from Raymond Dirks[194] to Barry Switzer,[195] then who else could possibly be out there free from prosecution? The directive arguably contemplates a final category of liability-free traders who have neither positional access nor a primary insider as the direct or indirect informational source. The latter half of this disjunctive is difficult to comprehend. The broad definition of inside information, while source neutral as between insiders and outsiders under United States law, clearly depends on information from primary insiders, by their definition, as the generating source. Consequently, the supposed "third group" theoretically cannot exist. Thus, similar to *Cady, Roberts* and the First Proposal, one may conclude that all persons who take advantage of inside information "with full knowledge of the facts by acquiring or disposing of [securities] for his own account or for the account of a third party, either directly or indirectly,"[196] would be deemed in violation of the directive's trading rule. At least for the purposes of the trading prohibition, no meaningful distinction exists between primary and secondary insiders or between those two categories and, if they exist, the rest of the world's possessors of inside information.

C. *Transactional Advantage*

Liability under the directive's trading rule depends not only on one's possession of inside information and one's status as a primary or secondary insider but also on two additional elements: "Taking advantage"[197] and acting "with full knowledge of the facts."[198] "Taking advantage" does not appear problematic. The "taking advantage" element appeared in the First Proposal and, despite the directive's numerous revisions, was adopted without change. The directive prohibits "taking advantage . . . by acquiring or disposing of . . . securities . . . to which [the inside] information relates."[199] This language does not require a profit made or a loss avoided but only an acquisition or disposition for one's own or another's account. Although specific benefit to the trader might be presumed, it does not appear to be required. The requisite advantage is defined as the transaction

191. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

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

193. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

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

195. SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

196. Insider Trading Directive, *supra* note 3, art. 2(1).

197. *Id.*

198. *Id.*

199. *Id.*

itself. Similar to the SEC's *Cady, Roberts* rule, the transactional advantage element supplies the formula, PI - D + T = L, *i.e.*, possession (P) of inside information (I) minus public disclosure (D) plus trading (T) equals liability (L) for the primary and secondary insiders to whom the rule applies. This simple formula reflects a regulatory indifference to whether the inside information possessed by the insider was a significant factor in that insider's decision to trade at a certain time or whether the insider's trading decision was reached independently. The absence of these issues and of the obstacles presented in their proof should facilitate the enforcement of implementing national legislation by competent authorities. The possibility does exist, however, that various member states may modify the transactional advantage element by adding language that would impose proof of profit made or loss avoided. Member states could, of course, go even further by expanding the "taking advantage" language to require proof of transactional causation, a causal relationship between the possession of the inside information and the decision to trade. Enforcement of the trading rule, however, would be hampered significantly if competent authorities were forced to show not only that the insider traded while in possession of inside information, but also that the insider's possession of that information was the *quid pro quo* or actually motivated the trade. The causal nexus between possession and trading should be presumed, thereby providing a bright line rule for both investors and regulatory authorities.

D. Scienter

The required "transactional advantage," as the element of the trading rule constituting the physical part of the offense, is limited by the further requirement that the "taking advantage" be done with "full knowledge of the facts,"[200] which constitutes the mental part of the offense. The "full knowledge" language did not appear in the First Proposal, the Hoon Report, the Parliamentary Opinion, or the Amended Proposal, but, nevertheless, the language managed to find its way into the Common Position and was ultimately adopted in the final directive. While the prior drafts of the directive did not use the phrase "full knowledge of the facts" or the term "knowingly" in the trading prohibition applicable to primary insiders, these drafts did use the phrase "knowingly obtained the inside information" in the trading prohibition applicable to secondary insiders.[201] In the Common Position and final version, the term "knowingly" was deleted and the phrase "with full knowledge of the facts" was inserted in both the primary[202] and secondary insider trading prohibitions.[203] One writer, concluding that

200. *Id.*

201. First Proposal, *supra* note 14, art. 3(1); Amended Proposal, *supra* note 73, art. 3(1).

202. Common Position, *supra* note 80, art. 2(1); Insider Trading Directive, *supra* note 3, art. 2(1).

203. Common Position, *supra* note 80, art. 4; Insider Trading Directive, *supra* note 3, art. 4.

the phrase is synonymous with the term "knowingly," has stated that the directive thereby establishes a requirement of scienter.[204] But the scienter requirement does not embrace an intent to deceive or defraud; it requires only an intent to trade the securities to which the inside information relates. That writer has stated further that "the decisive movement is the one in which the insider *knowingly* gives the order or else performs the transaction."[205] In other words, the phrase "with full knowledge of the facts" simply means that "the insider knows what he does in physically ordering the trade."[206] This conclusion, however, is hardly dispositive of the scienter issue.

The directive's scienter language imposes a requirement that the primary insider be shown to have "taken advantage" with full knowledge that the information was, in fact, "inside information." The language obviously was not intended to condition liability on the trader's full knowledge of the facts constituting the entire body of the inside information itself. Rather, liability is conditioned on the full knowledge that the partial or complete set of facts in the trader's possession was price-sensitive, nonpublic, precise, market information. As one commentator has opined, the directive's scienter requirement, devoid of any link to fraud or breach of fiduciary duty, conditions liability on proof that the insider had actual knowledge, not that he "should have known," that the information possessed constituted "inside information."[207] This accords with the position of the British, who objected to prior drafts of the directive which "did not require a primary insider to know that the information that he had was inside information."[208] The British objections were withdrawn following the Council's inclusion of the phrase "with full knowledge of the facts" in the Common Position.[209] What remains unclear is whether the full knowledge element of the trading rule requires a further showing not only that the insider had knowledge that the data possessed was inside information but also that the insider had as his purpose, aim or design the violation of the directive's trading prohibition. Because the directive provides no guidance on the issue of whether the trader's knowledge or objective, or a combination of the two, is necessary to satisfy the scienter requirement, member states have been left with considerable discretion in fashioning various *mens rea* elements of the offense.

E. Additional Elements of the Trading Rule

The four common elements discussed above establish the directive's trading rule as applied to primary insiders. In a separate article of the

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204. Hopt, *supra* note 47, at 67.

205. *Id.*

206. *Id.*

207. Note, *A Comparative Analysis*, *supra* note 3, at 239.

208. *Changes in Insider Rules Make Directive 'Useful,'* 2 Int'l Sec. Reg. Rep. (BNA) No. 14, at 2 (June 21, 1989).

209. *Id.*

directive, the application of the trading rule is extended to secondary insiders—those persons other than primary insiders who possess inside information which directly or indirectly derives from a primary insider.[210] The primary insider source, as noted previously, goes to the definition of secondary insiders and, perhaps, might be viewed solely as the definitional criteria for the "insider" status element under the trading rule. Nevertheless, proof of source clearly is a supplementary condition to liability for those other than primary insiders who purportedly engage in insider trading in violation of the directive. However, given its broad definitions of inside information and primary insiders, the directive states a limitation which confounds one's imagination. Although the limitation to primary source information negatively infers that inside information might exist which does not have a primary source, a rational search for that phantom data can only be futile.

The futility of the search and, indeed, the superfluity of the primary insider source limitation become obvious when one considers the secondary insider's options as to source under his peculiar trading rule. If the secondary insider gains the information by virtue of the exercise of his employment or duties, then he becomes a primary insider, and his trade is prohibited by the trading rule as applied to primary insiders. This is the likely fate of most would-be secondary insiders. If he steals the information from a primary insider through industrial espionage or otherwise, then his source is clearly the primary insider. Contrary to United States law, the EC's secondary insider trading rule applies regardless of whether the inside information was legally provided to or wrongfully obtained by the tippee or any other secondary insider.[211] If the secondary insider discovers the information fortuitously in a misdirected telefax, a lost briefcase, or in an overheard conversation, all emanating from a primary insider, his source clearly is that primary insider. If he receives a lawful or unlawful tip from a third party regarding inside information originally emanating from a primary insider, his source is, at least "indirectly," a primary insider. Virtually all information is, of course, "inside" if it is nonpublic, precise, price-sensitive, market information. All such information by definition initially must be generated by primary insiders, whether company management or employees, journalists, bankers or government agents. The secondary insider, therefore, might be a nontippee, a tippee, a subtippee, or a sub-subtippee. According to one writer, "the whole chain . . . is caught," and it is unnecessary to prove who was the primary insider or where the leak has occurred.[212] The trader's status as a secondary insider results from his not being a primary insider and from his possession of inside information. The primary source language does not restrict the directive's applicability. The language serves only to reaffirm the distinct status of the

210. Insider Trading Directive, *supra* note 3, art. 4.

211. *See supra* note 126.

212. Hopt, *supra* note 47, at 71.

secondary insider and the linkage between the information he possesses and the primary insider from which that information must necessarily emanate. Once his status as a secondary insider is established, the trader should look not to the source of the information but to the scienter element when he seeks to defend his securities trades against attack under the directive.

F. Additional Elements of the Tipping Rule

The Insider Trading Directive's tipping rule incorporates two of the common elements previously analyzed: Inside information and the possession of that information by a primary insider. Once these elements are established, one of two predicate acts must be shown: (1) The disclosure to a third party (unless in the normal course of the primary insider's exercise of his employment, profession or duties);[213] or (2) the recommendation or procurement of a third party, on the basis of that information, to acquire or dispose of the securities to which the information relates.[214] Thus, the tipping rule bans both selective disclosure and tipping activities, respectively. The tipping rule, like the trading rule, requires no fraud, breach of fiduciary duty or other wrongful behavior in tort or contract. Unlike the directive's trading rule, the tipping rule does not require that the primary insider act with scienter; it completely omits the language "knowingly" or "with full knowledge of facts."

The first of the alternative predicate acts to liability under the tipping rule is the prohibition on disclosure to a third party.[215] The disclosure prohibition relates only to inside information which, by definition, has not been disclosed to the investing public. This broad ban on disclosure to the favored few goes significantly further than the ban on insider trading. The primary insider is not only denied the right to trade but is also denied the right to discriminate among investors or others in sharing inside information. While the trading rule, as applied to both primary and secondary insiders, would prohibit trading based on inside information, the tipping rule is designed to keep the inside information out of the market until disseminated to investors generally. Thus, would-be recipients of the selective disclosure are deprived of opportunities to refrain from trading based on that information, the "omission of transactions" area that insider trading regulation historically has failed to address.[216] Moreover, potential chains of tippees and subtippees are pretermitted by a rule that does not require knowledge,

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213. Insider Trading Directive, *supra* note 3, art. 3(a).

214. *Id.* art. 3(b).

215. *Id.* art. 3(a).

216. Those who possess inside information benefit considerably in the development of trading strategies that include decisions not to buy and not to sell securities at a given time. The obvious advantages to non-trading insiders resulting from informational asymmetries cannot be affected by the trading rule but can be reduced significantly by the current disclosure rule and the tipping rule. Assuming compliance, these two rules serve, respectively, to limit the duration of the advantage by requiring prompt public disclosure and to limit access to the information by proscribing selective disclosure to others.

or a reasonable belief, that the tippee will engage in trading activities based on the disclosed information. In fact, no likely or actual trading by the recipient tippees is required under the disclosure rule. Certainly, the disclosure restraint, if fully implemented, will contribute to the goal of informational parity. The restraint is subject, however, to the potentially far-reaching exception "unless disclosure is made in the normal course of the exercise of his employment, profession or duties."[217] The breadth of the "normal course" exception to the disclosure restraint of the tipping rule is difficult to predict. Undoubtedly, financial services firms will advance arguments that this exception is intended to sanitize communications between issuers on the one hand and financial analysts and portfolio managers on the other, who seek inside information in order to make forecasts and risk allocations. Others will argue that the exception permits cracks in the "Chinese walls" of brokerage firms and universal banks where disclosure of inside information on one side of the wall is considered necessary to protect the beneficiaries of the firm's "duties" on the other side of that wall.[218] The unexplained adoption of the vague "normal course" exception is highly suspect and could seriously undermine the EC's policy objectives. This exception conceivably could swallow the rule.

The second of the tipping rule's alternative predicate acts is the prohibition on recommending or procuring a third party to trade the securities to which the inside information relates.[219] This provision prohibits the inside information-based "hot tip," without regard to whether that underlying inside information actually is disclosed. This "hot tip" rule adds needed clarity to the EC's insider trading jurisprudence. It recognizes the "hot tip" as the burning essence of a large mass of inside information. In doing so, the rule sidesteps conventional defensive arguments that the "hot tip," without more, is only rumor and that no actual inside information was revealed. The "hot tip" rule should be viewed as an impressive advance in insider trading regulation.

Most unfortunately, the EC did not extend the tipping rule to secondary insiders. The Commission and the European Parliament, as described previously, strongly supported the rules's application to both primary and secondary insiders.[220] Faced with powerful opposition from the financial services industry, the Council excluded tippees and other secondary insiders in adopting its Common Position.[221] Subsequently, the European Parliament struggled in vain to have the rule reimposed on tippees and other secondary insiders.[222] Instead, the Council added language to the directive authorizing the member states, in their discretion, to extend application of the tipping

217. Insider Trading Directive, *supra* note 3, art. 3(a).

218. *See* N. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS 227-236 (1991).

219. Insider Trading Directive, *supra* note 3, art. 3(b).

220. *See supra* notes 87, 93, 186 and accompanying text.

221. Common Position, *supra* note 80, art. 3.

222. Second Parliamentary Opinion, *supra* note 92, at 54.

rule to secondary insiders.[223] The achievement of a basic insider trading prohibition in most of the member states will become reality only as a result of the EC mandate set forth in the directive. Without a similar mandate for extending the tipping rule to secondary insiders, national legislation with more stringent and broader application is sheer fantasy at the present time.

V. The Exclusions from the Trading and Tipping Rules

The Insider Trading Directive contains a number of important exclusions from coverage. Similar to the host of exclusions in other areas of regulation, the directive's exclusions are likely to reduce the overall effectiveness of the trading and tipping rules to be adopted by the member states. Several of these exclusions have been mentioned previously, including those related to a bidder's takeover decisions,[224] analysts' estimates developed from publicly available data,[225] and normal market making, brokerage and stabilization activities by investment firms, the knowledge of which might have otherwise constituted possession of inside information.[226] The exclusion of secondary insiders from the tipping rule also has been discussed at length.[227] In addition to these, the directive sets forth other noteworthy exclusions. Communication of inside information to regulatory authorities is excluded from the directive's tipping rules.[228] Governmental transactions taken in pursuit of national monetary, exchange rate or public debt management policies are excluded from the directive.[229] In language that can only be described as obfuscated, the directive permits the member states to exclude from coverage all face to face transactions taking place outside a regulated market and not involving a professional intermediary.[230] Finally, the directive does not apply to corporations and other legal persons but only to natural persons acting individually or on the legal person's behalf.[231]

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223. Insider Trading Directive, *supra* note 3, art. 6. Article 6 provides:

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

Id.

224. *Id.* preamble.

225. *Id.*

226. *Id.*

227. *See supra* notes 220-223 and accompanying text.

228. Insider Trading Directive, *supra* note 3, preamble.

229. *Id.* art. 2(4).

230. *Id.* art. 2(3). This exclusion, while hardly salutary, is consistent with the directive's focus on market function and the consequential disregard for the position of individual investors. If the transaction is truly off-market and a market professional is not involved, then the participants in the transaction are unaffected by the directive's rules. Member states, of course, have the authority to extend the scope of the prohibition. *See supra* note 223.

231. *Id.* art. 2(2).

The exclusion from coverage of legal persons finds its origin in the British and French insider trading laws, which, in their relatively brief history, have not recognized civil or criminal liability for insider trading violations by corporations.[232] Borrowing from the French law, the Commission, in its Amended Proposal, added language applying the trading rule to *de jure* or *de facto* directors in cases where the insider trading has been conducted on behalf of a legal person.[233] This provision, according to one writer, would have made corporate directors "automatically and strictly liable" whenever a legal person was guilty of violating the trading rule.[234] Others expressed the view that violations by subordinates would result in liability being imposed on corporate directors who neither approved nor were aware of the wrongful transactions.[235] In response to these objections, the Council revised the Commission's language to impose liability only on those "natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned."[236] The imposition of personal liability on those individual corporate personnel directly participating in an insider trading scheme should serve as a powerful deterrent while commendably avoiding economic harm to the innocent shareholders of the corporate entity. However, these benefits must be balanced against the provision's reduction, indeed arguable elimination, of vicarious liability. If no liability is imposed on either the corporation or its board of directors, then the corporation has little or no incentive to establish and enforce internal compliance programs. The directive, unlike recent insider trading legislation enacted in the United States,[237] fails to establish any prohibitions or regulatory incentives that would mandate or encourage corporate responsibility for insider trading by corporate employees. The absence of controlling person liability,[238] respondeat superior[239] or any statutory require-

232. Wallace, *Who is Subject to the Prohibition Against Insider Trading: A Comparative Study of American, British and French Law*, 15 Sw. U.L. Rev. 217, 277 (1985).

233. Amended Proposal, *supra* note 73, art. 1(2).

234. Dine, *supra* note 3, at 23.

235. *See, e.g.*, Cohen, Fidler & Dickson, *supra* note 174; *A Daft Draft*, *supra* note 24, at 86-87.

236. Insider Trading Directive, *supra* note 3, art. 2(2).

237. The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C.). The Insider Trading and Securities Fraud Enforcement Act subjects investment firms and other controlling persons to substantial penalties for failing to take appropriate steps to prevent "insider trading," still undefined, by their employees. 15 U.S.C. § 78u-1(b)(1) (1988). *See generally* Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. Rev. 465 (1990).

238. The Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1988), extends liability for the acts of one person to another, who, through stock ownership, agency or agreement, "controls" that person. The SEC, in rule 12b-2, has defined the term "control" to mean "the possession, direct or indirect, of the power to direct..the management and policies of a person, whether through the ownership of voting securities , by contract or otherwise." 17 C.F.R. § 240.12b-2 (1991).

239. The common law doctrine of respondeat superior deems an employer liable for all acts of an employee committed within the scope of employment. Restatement (Second) of

ments for internal control and surveillance systems represents a major weakness in the directive. Moreover, this deficiency may undermine the EC's commitment to the efficacy of its insider trading prohibitions.

VI. Penalties and Enforcement

The Insider Trading Directive, after having broadly proscribed both trading and tipping, collapses in its failure to establish the criminal nature of the two prohibitions and the types and severities of the penalties and other remedies that must be imposed by the member states. The EC, after rejecting calls for harmonized civil and criminal remedies,[240] opted for the following standard: "The penalties shall be sufficient to promote compliance with those measures [enacted pursuant to the directive]."[241] The directive's language provides an extraordinarily wide margin of discretion to the member states as they undertake the transformation of the directive. This deficiency illustrates, even more than the exclusion of liability for legal persons, the absence of intense regulatory concern over insider trading abuses. It also illustrates, as one must concede, the enormous political obstacles confronting the Commission in its valiant attempt to reverse decades of European regulatory indifference.[242]

One can only engage in informed speculation as to the probable result of transformation. Some member states, like Germany, may provide merely for the disgorgement of trading profits, a civil remedy that results in a loss no greater than one's gain.[243] Despite the directive's authorization to member states to adopt more stringent measures than those mandated,[244] the directive's failure to require a minimum level of penalties or even to define the prohibited conduct as criminal encourages the member states to enact legislation that simply passes muster. Because no harmonization of penalties or other remedies is required, few member states are likely to opt for harsh penalties that might place their capital markets at a regulatory disadvantage. Moreover, the absence of an EC mandate for harmonized penalties leaves member states' authorities unarmed in their efforts to overcome domestic political recalcitrance to an enhanced regulatory scheme. The result of the EC's failure to prescribe harmonized criminal penalties and civil remedies is likely to be a patchwork of twelve widely disparate regimes with an array

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Agency § 228 (1958). *See* Musewicz, *Vicarious Employer Liability and Section 10(b): In Defense of the Common Law*, 50 Geo. Wash. L. Rev. 754 (1982).

240. Hoon Report, *supra* note 52, at 10; Parliamentary Opinion, *supra* note 51, at 92-93.

241. Insider Trading Directive, *supra* note 3, art. 13.

242. The Commission traditionally has not specified actual sanctions in its proposed directives; rather, the Commission has followed the principle that sanctions should remain the exclusive prerogative of the member states. This principle should be abandoned if regulatory harmony is to be achieved.

243. *See* Hopt, *European Directive*, *supra* note 3, at 75-76.

244. *See supra* note 223.

of hard and soft sanctions easily exploited by those intent on profiting from the disparities.

Enforcement may prove equally disastrous to the efficacy of the directive. Although frequent suggestions have been put forward for a supranational securities regulatory agency for the EC,[245] they have received no serious consideration to date. The directive requires each member state to designate a competent authority or set of authorities to ensure that the implementing legislation is applied.[246] These competent authorities must be provided both supervisory and investigatory powers necessary to perform their enforcement responsibilities.[247] They are required to cooperate with each other in fulfilling their enforcement function, including the exchange of information.[248] The benefits from member states' cooperation in their enforcement efforts should be strongly complemented by the Council of Europe's recently adopted Convention on Insider Trading and its Protocol.[249] The directive's requirements for collaborative national agencies with investigatory and supervisory powers, viewed optimistically, could lead to a cooperative enforcement network which might evolve into, or influence the development of, a centralized secretariat, which, in turn, might ultimately be given independent regulatory authority.[250] A central authority would contribute enormously to the coordination of the enforcement network envisaged by the directive and to the development of enhanced EC inside trading standards and increasingly harmonized national legislation.[251] One must remain hopeful that the directive is just the first step on the path to a comprehensive and effectively enforced insider trading regulatory scheme.[252]

VII. Conclusion

The EC, in its adoption of the Insider Trading Directive, has achieved a major advance in the development of a supranational securities code for

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245. *See* Warren, *supra* note 25, at 231.

246. *See supra* note 56.

247. Insider Trading Directive, *supra* note 3, art. 8(2).

248. *Id.* art. 10(1); *see supra* note 89.

249. Convention on Insider Trading, *opened for signature* Apr. 20, 1989, Europ. T.S. No. 130. *See* Lowry, *The International Approach to Insider Trading: The Council of Europe's Convention*, 1990 J. Bus. L. 460.

250. *See* Warren, *supra* note 25, at 231.

251. *See id.*

252. The Insider Trading Directive, according to one commentator, was conceived as "a first step towards an increasingly effective system for combating insider trading." Fornasier, *supra* note 70, at 169. The directive provides that the "Contact Committee," established under the Admissions Directive, *supra* note 31, would have as additional functions:

> (a) to permit regular consultation on any practical problems which arise from the application of this Directive and on which exchanges of view are deemed useful;
> (b) to advise the Commission if necessary, on any additions or amendments to be made to this Directive.

Insider Trading Directive, *supra* note 3, art. 12. Thus, a mechanism has been put in place to oversee issues likely to arise during the process of transformation.

the common market. The EC must be credited with being the first body to establish multinational insider trading laws. It also must be credited with defining an offense that the United States Congress and the SEC have never been willing or able to define. Moreover, the EC, in developing its trading and tipping rules, has avoided the duty-based jurisprudence that has been the curse of insider trading laws in the United States. Under the EC's three substantive rules, regulatory authorities in the member states need not demonstrate any breach of duty, whether in tort or contract, as those duties vary from member state to member state. These authorities, instead, must look to the directive's three specific statutory prohibitions as transformed into their respective national laws.

The directive's first general rule is that insiders in possession of inside information, a term defined to include market information, cannot trade. The term "insider," combining primary and secondary insiders, embraces virtually all traders who possess inside information. The directive's second general rule is that primary insiders may not disclose inside information selectively, regardless of any exploitative design or activity by those favored with the disclosure and regardless of whether the inside information itself is disclosed or is transmitted in its bare essence in the form of a "hot tip" recommending a trade. The EC's third general rule is not prohibitory, but prophylactic, and applies not to insiders, but to issuers of securities. This rule requires publicly-held issuers to disclose promptly all major new developments which might lead to substantial movement in their share prices and thereby reduces insider trading opportunities in the marketplace. Finally, the directive obliges each of the member states to designate or establish regulatory agencies, with full investigatory and supervisory powers, to enforce these trading, tipping and disclosure rules, both independently and in cooperation with each other. Because insider trading is increasingly multijurisdictional in scope, involving opposite traders, professional intermediaries, and securities markets that may be located in different nations, multistate cooperation in enforcement has become essential.[253] The directive envisages a cooperative network of member state authorities sharing common goals, common rules and common zeal in enforcing the insider trading prohibitions.

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253. A former SEC Commissioner has underscored the necessity for international cooperation in policing the world's integrated securities markets:

> Securities fraud is more than an international problem that requires an international solution. The reality of today's marketplace is that if we fail to develop effective means of international cooperation none of us will be able to enforce even our own laws against our citizens trading in our own domestic markets. Thus, either we learn to cooperate in the international area or we surrender our domestic regulatory regimes and resign ourselves to a world in which securities and other financial regulations are mere statements of symbolic aspirations that are evaded with impunity by international traders.

Grundfest, *International Cooperation in Securities Enforcement: A New United States Initiative*, Address at King's College, London (Nov. 9, 1988).

Despite the EC's vision and its imperative to the member states, the member states do not share the values of an American jurisprudence that "abhors insider trading with a fervor reserved for those who scoff at motherhood, apple pie and baseball."[254] The moral and political compromises reached during the development of the Insider Trading Directive provide ample evidence of their mellow approach to this stubbornly resistant form of market abuse. The final directive, while firmly establishing insider trading as a European sin, replete with a common moral text, fails to unite its trading and tipping rules against all insiders, whether primary or secondary, in possession of inside information. Further, the directive provides a diluted version of the materiality criterion used in its definition of inside information. But these deficiencies pale when compared with more significant regulatory lapses in the directive. Corporate entities, as legal persons, are exempted from direct liability under the trading and tipping rules. Although those individual agents "who take part in the decision" are subject to the prohibitions, the entity, as well as its governing board, is freed from vicarious liability. Thus, corporate management, by refraining from involvement in trading decisions, has no regulatory incentive to ensure the required behavior of its personnel. The directive imposes no requirements on corporate employers to develop internal compliance programs, contractual restraints, or surveillance procedures designed to reduce or control violations by either employees or other agents. Moreover, the directive fails to state that insider trading shall be a crime, fails to state any minimum jail sentences and fines, and fails to state any administrative or civil remedies or sanctions. Because remedial measures are left to the discretion of the twelve member states, governed solely by the standard "sufficient to promote compliance," little hope remains for the degree of harmonization the directive seeks to achieve, even on its face. Lax enforcement will only compound the dilemma.

The directive, despite its inherent weaknesses, does allow one sanguine view. Its triplex of rules should contribute both to increased regulatory parity and to a significant elevation of preexisting regulatory thresholds. By mandating statutory prohibitions, even without common penalties, in each of the member states, the EC has thrown the full weight of the union it constitutes behind its moral and legal condemnation of behavior previously regarded as an acceptable norm in the business ethics of the European marketplace. The directive is a first, giant step toward the EC's interrelated goals of harmonization and improved market function. The Commission should zealously monitor the directive's transformation into national laws and the enforcement of those rules. Having leaped the barriers necessary to secure any insider trading legislation from its constituents, the Commission is better positioned to initiate revisions in the future. Viewed as the first step of a number to come, the directive is a remarkable achievement for the EC's securities markets and the global investor.

254. Cox, *supra* note 119, at 628.