



Speech by SEC Staff: Insider Trading – A U.S. Perspective

Remarks by

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I. Introduction

More Americans are investing in the stock market than ever before and Americans now have almost twice as much money invested in the stock market as in commercial banks.² We believe this reflects Americans' trust and confidence in the American stock markets and that trust stems from a belief that our government relentlessly pursues its mandate to maintain the fairness and integrity of the stock markets. As Chairman Levitt of the United States Securities and Exchange Commission ("SEC" or "Commission") recently observed in an address to the legal and investment community:

Our markets are a success precisely because they enjoy the world's highest level of confidence. Investors put their capital to work – and put their fortunes at risk – because they trust that the marketplace is honest. They know that our securities laws require free, fair, and open transactions.³

An essential part of our regulation of the securities market is the vigorous enforcement of our laws against insider trading, an enforcement program, the Chairman noted, that "resonate[s] especially profoundly" among American investors.⁴ The enforcement program includes both civil and criminal prosecution of insider trading cases. In the fiscal year ended September 30, 1997, the Commission brought 57 insider trading cases.⁵

II. The Insider Trading Debate

"Insider trading" is a term subject to many definitions and connotations and it encompasses

both legal and prohibited activity. Insider trading takes place legally every day, when corporate insiders – officers, directors or employees – buy or sell stock in their own companies within the confines of company policy and the regulations governing this trading.

The type of insider trading we discuss here is the illegal variety that most of us think of when we hear the term; the type of insider trading that achieved wide-spread notoriety in the 1980s with the SEC's civil cases and the United States Department of Justice's criminal cases against Michael Milken and Ivan Boesky and which inspired even Hollywood's imagination with the movie "Wall Street". It is the trading that takes place when those privileged with confidential information about important events use the special advantage of that knowledge to reap profits or avoid losses on the stock market, to the detriment of the source of the information and to the typical investors who buy or sell their stock without the advantage of "inside" information.

Today, we are seeing a resurgence of the insider trading of the 1980s. The United States is again experiencing "merger mania." By mid-August of this year, takeovers and acquisitions orchestrated by Wall Street already totaled \$1.2 trillion dollars, compared to \$920 billion in all of last year.⁶

The American notion that insider trading is wrong was well-established long before the passage of the federal securities laws. In 1909, the United States Supreme Court held that a director of a corporation who knew that the value of the stock of his company was about to skyrocket committed fraud when he bought company stock from an outsider without disclosing what he knew.⁷ But this condemnation is not universal, even in the United States.

Those who oppose prohibiting insider trading advance many arguments, most of which fall on their own weight.

- Some argue that insider trading is a legitimate form of compensation for corporate employees, permitting lower salaries that, in turn, benefits shareholders. It provides an incentive to innovation, some argue, by promising huge rewards for developing a plan or product that will lead to a precipitous rise in the stock.⁸ This argument, however, fails to address the real and significant hazard of creating an incentive for corporate insiders to enter into risky or ill-advised ventures for short term personal gain, as well as to put off the public release of important corporate information so that they can capture the economic fruits at the expense of shareholders.
- Others have argued that American reliance on several antifraud provisions, and the absence of a statutory definition of insider trading, may lead to unfairly penalizing traders whose conduct comes close to the line.⁹ This seems an illusory concern. There are at least two compelling reasons for this. First, *scienter*, a fraudulent intent, is an element that must be proven.¹⁰ Second, given the inherent difficulties in investigating and proving insider trading cases, the reality is that there is a significant amount of clearly illegal activity that goes undetected or unpunished. As SEC Chairman Levitt recently observed, "It's not as if insider traders wander innocently into the gray areas near the boundaries of legality. They willfully stride across the bright line of the law."¹¹
- Another argument advanced by critics is that strict insider trading regulation may have a chilling effect on the work of securities analysts, prohibiting "sensible dialogue" between company officials and analysts.¹² The empirical evidence is to the contrary. Thousands of analysts ply their important trade in the United States diligently, effectively and within the law. In its history, the Commission has brought only two insider trading cases even touching on the company-analyst exchange of information – one where the Commission alleged that the chief executive officer of a corporation, in

breach of his duty to the company, tipped several securities analysts in advance of earnings announcements in order to protect his reputation and continued earnings power;¹³ the other, where the Commission alleged that an analyst traded based on material non-public information misappropriated from his employer.¹⁴

- We recognize the important role that analysts play in our markets and seek to encourage legitimate research.¹⁵ Nevertheless, the Commission is concerned about selective corporate disclosure of material information to favored analysts prior to public disclosure and the resulting threat to market fairness when the favored few get to trade prior to public disclosure. Currently, this is an area of special concern to the Commission because we have seen several cases of unusual trading in the interval between a company's disclosure of price sensitive information to analysts and disclosure of the information to the public. Chairman Levitt made the Commission's position clear: "Legally, you can split hairs all you want. But, ethically, its very clear: If analysts or their firms are trading – knowing this information, and prior to public release – it's just as wrong as if corporate insiders did it."¹⁶ The Commission will be looking very closely at these cases as they arise.
- Finally, there are those who argue that insider trading is a victimless offense and that enforcing insider trading prohibitions is simply not cost effective; the amount of money recovered does not justify the money and human capital spent on investigating and prosecuting insider traders.¹⁷ With respect to equities trading, it may well be true that public shareholders' transactions would have taken place whether or not an insider was unlawfully in the market. But the options market presents a different story. Professional option writers write options only in response to a particular demand. Where that demand comes from an insider possessing material non-public information, the option writer suffers a loss that would not otherwise have occurred.¹⁸ Additionally, this penny-wise, pound-foolish argument neglects the external costs that result from a perception that insider trading is unchecked. In fact, as regulators throughout the world are discovering, governments cannot afford to turn a blind eye to insider trading if they hope to promote an active securities market and attract international investment. As one commentator on the subject observed:

But one of the main reasons that capital is available in such quantities in the U.S. markets is basically that the investor trusts the U.S. markets to be fair. Fairness is a major issue. Even though it sounds simplistic, it is a critical factor and one that is absent, really to a surprising degree in many of the sophisticated foreign markets. . . . The common belief in Europe that certain investors have access to confidential information and regularly profit from that information may be the major reason why comparatively few Europeans actually own stock. [This may] partially explain why the U.S. markets are so active and why so much money is available for those companies that seek to enter U.S. markets.¹⁹

Indeed, the European Economic Community has formally recognized the importance of insider trading prohibitions by passing a directive requiring its members to adopt insider trading legislation. The preamble to the directive stresses the economic importance of a healthy securities market, recognizes that maintaining healthy markets requires investor confidence and acknowledges that investor confidence depends on the "assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information."²⁰ These precepts echo around the world as reports of increased insider trading regulation and enforcement efforts are daily news.

III. Insider Trading Law in the United States

Rooted in the common law tradition of England, on which our legal system is based, we have relied largely on our courts to develop the law prohibiting insider trading. While Congress gave us the mandate to protect investors and keep our markets free from fraud, it has been our jurists, albeit at the urging of the Commission and the United States Department of Justice, who have played the largest role in defining the law of insider trading.

After the United States stock market crash of 1929, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, aimed at controlling the abuses believed to have contributed to the crash. The 1934 Act addressed insider trading directly through Section 16(b) and indirectly through Section 10(b).

Section 16(b) prohibits short-swing profits (profits realized in any period less than six months) by corporate insiders in their own corporation's stock, except in very limited circumstance. It applies only to directors or officers of the corporation and those holding greater than 10% of the stock and is designed to prevent insider trading by those most likely to be privy to important corporate information.

Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful for any person "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." To implement Section 10(b), the SEC adopted Rule 10b-5, which provides, in relevant part:

It shall be unlawful for any person, directly or indirectly . . . ,
(a) to employ any device, scheme, or artifice to defraud,
(b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security.²¹

These broad anti-fraud provisions, make it unlawful to engage in fraud or misrepresentation in connection with the purchase or sale of a security.²² While they do not speak expressly to insider trading, here is where the courts have exercised the authority that has led to the most important developments in insider trading law in the United States.

The breadth of the anti-fraud provisions leaves much room for interpretation and the flexibility to meet new schemes and contrivances head on. Moral imperatives have driven the development of insider trading law in the United States. And the development of insider trading law has not progressed with logical precision as the reach of the anti-fraud provisions to cover insider trading has expanded and contracted over time.

The anti-fraud provisions were relatively easy to apply to the corporate insider who secretly traded in his own company's stock while in possession of inside information because such behavior fit within traditional notions of fraud. Far less clear was whether Section 10(b) and Rule 10b-5 prohibited insider trading by a corporate "outsider." In 1961, in the case of *In re Cady Roberts & Co.*,²³ the Securities and Exchange Commission, applying a broad construction of the provisions, held that they do. The Commission held that the duty or obligations of the corporate insider could attach to those outside the insiders' realm in certain circumstances. The Commission reasoned in language worth quoting:

Analytically, the obligation [not to engage in insider trading] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.²⁴

Based on this reasoning, the Commission held that a broker who traded while in possession of nonpublic information he received from a company director violated Rule 10b-5. The Commission adopted the "disclose or abstain rule": insiders, and those who would come to be known as "temporary" or "constructive" insiders, who possess material nonpublic information, must disclose it before trading or abstain from trading until the information is publicly disseminated.

Several years later in the case of *SEC v. Texas Gulf Sulphur Co.*, a federal circuit court supported the Commission's ruling in *Cady*, stating that anyone in possession of inside information is required either to disclose the information publicly or refrain from trading.²⁵ The court expressed the view that no one should be allowed to trade with the benefit of inside information because it operates as a fraud all other buyers and sellers in the market.²⁶ This was the broadest formulation of prohibited insider trading.

The 1980s were an extraordinary time in this country's economic history, marked by a frenzy of corporate takeovers and mergers involving what then were dazzling amounts of money. Insider trading reached new heights. Ironically, it is during this period that courts narrowed the scope of Section 10(b) and Rule 10b-5 in the insider trading context.

In the 1980 case of *Chiarella v. United States*, the United States Supreme Court reversed the criminal conviction of a financial printer who gleaned nonpublic information regarding tender offers and a merger from documents he was hired to print and bought stock in the target of the companies that hired him.²⁷ The case was tried on the theory that the printer defrauded the persons who sold stock in the target to him. In reversing the conviction, the Supreme Court held that trading on material nonpublic information in itself was not enough to trigger liability under the anti-fraud provisions and because the printer owed target shareholders no duty, he did not defraud them. In what would prove to be a prophetic dissent, Chief Justice Burger opined that he would have upheld the conviction on the grounds that the defendant had "misappropriated" confidential information obtained from his employer and wrongfully used it for personal gain.

In response to the *Chiarella* decision, the Securities and Exchange Commission promulgated Rule 14e-3 under Section 14(e) of the Exchange Act, and made it illegal for anyone to trade on the basis of material nonpublic information regarding tender offers if they knew the information emanated from an insider.²⁸ The purpose of the rule was to remove the *Chiarella* duty requirement in the tender offer context – where insider trading was most attractive and especially disruptive.

In 1981, the Second Circuit adopted the "misappropriation" theory, holding in the case of *United States v. Newman*²⁹ that a person with no fiduciary relationship to an issuer nonetheless may be liable under Rule 10b-5 for trading in the securities of an issuer while in possession of

information obtained in violation of a relationship of trust and confidence. Newman, a securities trader, traded based on material nonpublic information about corporate takeovers that he obtained from two investment bankers, who had misappropriated the information from their employers.

Three years later in *Dirks v. SEC*,³⁰ the Supreme Court reversed the SEC's censure of a securities analyst who told his clients about the alleged fraud of an issuer he had learned from the inside before he made the facts public. *Dirks* was significant because it addressed the issue of trading liability of "tippees": those who receive information from the insider tipper. *Dirks* held that tippees are liable if they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper received a direct or indirect personal benefit from the disclosure. Because the original tipper in *Dirks* disclosed the information for the purpose of exposing a fraud and not for personal gain, his tippee escaped liability.

A significant aspect of the decision was contained in a footnote to the opinion, which has come to be known as "*Dirks* footnote 14." There, Justice Powell formulated the concept of the "constructive insiders" – outside lawyers, consultants, investment bankers or others – who legitimately receive confidential information from a corporation in the course of providing services to the corporation. These constructive insiders acquire the fiduciary duties of the true insider, provided the corporation expected the constructive insider to keep the information confidential.

The Second Circuit again addressed the misappropriation theory in the 1986 case of *United States v. Carpenter*.³¹ The case centered on a columnist for the Wall Street Journal, whose influential columns often affected the stock prices of companies about which he wrote. The columnist tipped information about his upcoming columns to a broker (among others) and shared in the profits the broker made by trading in advance of publication.³² In upholding the convictions of the columnist and the broker for securities fraud under Rule 10b-5 and mail and wire fraud, the Second Circuit rejected the defendants' argument that the misappropriation theory only applies when the information is misappropriated by corporate or constructive insiders, holding "[T]he misappropriation theory more broadly proscribes the conversion by insiders' or others of material non-public information in connection with the purchase or sale of securities."³³

The case was appealed to the Supreme Court. The Supreme Court unanimously agreed that Carpenter engaged in fraud, but divided evenly on whether he engaged in securities fraud.³⁴ But in unanimously affirming the mail and wire fraud convictions, the Court quoted an earlier New York decision that ruled: "It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principle for any profits derived therefrom."³⁵

Over the next nine years, the misappropriation theory gained acceptance in federal courts.³⁶ Then in 1995 and 1996, two federal circuit courts rejected the misappropriation theory³⁷ on the grounds that the theory "requires neither misrepresentation nor nondisclosure" and that "the misappropriation theory is not moored [in] [section] 10(b)'s requirement that the fraud be "in connection with the purchase or sale of any security.""³⁸

Last year, in a landmark victory for the SEC, the Supreme Court reversed one of these decisions and explicitly adopted the misappropriation theory of insider trading in the case of *United States v. O'Hagan*.³⁹ O'Hagan was a partner in a law firm retained to represent a

corporation, Grand Met, in a potential tender offer for the common stock of the Pillsbury Company. When O'Hagan learned of the potential deal, he began acquiring options in Pillsbury stock, which he sold after the tender offer for a profit of over \$4 million. O'Hagan argued, essentially, that because neither he nor his firm owed any fiduciary duty to Pillsbury, he did not commit fraud by purchasing Pillsbury stock on the basis of material, nonpublic information.

The Court rejected O'Hagan's arguments and upheld his conviction. The Court held, significantly, that O'Hagan committed fraud in connection with his purchase of Pillsbury options, thus violating Rule 10b-5, based on the misappropriation theory.⁴⁰ In the Court's words:

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.⁴¹

In the course of its opinion, the Court identified two discrete arguments for prohibiting insider trading. First, the Court stressed that prohibiting insider trading is

. . . well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.⁴²

Second, the Court acknowledged the "information as property" rationale underlying insider trading prohibitions:

A company's confidential information . . . qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of a fiduciary duty . . . constitutes fraud akin to embezzlement – the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.⁴³

Although the law of insider trading in the United States is continuing to evolve, the decision in *O'Hagan* is a significant milestone in defining the scope of Rule 10b-5 insider trading prohibitions.

IV. The European Community Directive on Insider Trading

As United States lawmakers, courts and regulators struggled to refine prohibitions on insider trading, insider trading in the rest of the world markets, with few exceptions, went virtually unregulated prior to the 1980s. The first wide-ranging development outside the United States

in efforts to ban insider trading was the European Community Directive Coordinating Regulations on Insider Trading, adopted on November 13, 1989 (the "EC Directive").⁴⁴ The EC Directive arose out of the 1957 Treaty of Rome Establishing the European Economic Community, which mandated creating a single internal European financial market.⁴⁵

The EC Directive was thirteen years in the making; the first deliberations beginning in 1976.⁴⁶ In the 1980s, highly publicized insider trading scandals in New York involving Ivan Boesky and Michael Milken, among others, and in Europe involving the Guinness brewing group, gave a new urgency to developing a European-wide ban on insider trading.⁴⁷

The Directive was modeled after French and English insider trading prohibitions and went through a number of incarnations. In its final form, the Directive has an appealing structural simplicity. In sum,

- It defines "inside information" as information of a "precise nature" about security or issuer which has not been made public which, if it were made public, "would likely have a significant effect on the price" of the security (Article 1);
- It prohibits insiders from taking advantage of inside information (Article 2);
- It prohibits insiders from tipping or using others to take advantage of inside information (Article 3);
- It applies its prohibitions to tippees with "full knowledge of the facts" (Article 4);
- It requires each member to apply the prohibitions to actions taken within its territory with regard to securities traded on any members' market (Article 5);
- It provides that members may enact laws more stringent than set out in the Directive (Article 6);
- It requires issuers to inform the public as soon as possible of major events that may affect the price of the issuer's securities (Article 7);
- It requires members to designate an enforcement authority, to give it appropriate powers and to bind it to professional standards of confidentiality (Articles 8 and 9);
- It requires members to cooperate with each other in investigation efforts by exchanging information (Article 10);
- It leaves it up to individual members to decide on penalties for insider trading (Article 13); and finally,
- It required all members to enact legislation complying with the Directive by June 1, 1992 (Article 14).⁴⁸

Much has and can be said about how the Directive compares to the United States law on insider trading. A fundamental difference between the EC Directive and the United States' prohibition against insider trading under Section 10b and Rule 10b-5 as developed by the courts, is that the Directive does not require that the insider trader breach a fiduciary duty to the source of the information for liability to attach. In this respect, it mirrors the United States' prohibition against trading on the basis of nonpublic information about a tender offer under Section 14(e) of the Securities Exchange Act of 1934 and the Commission's Rule 14e-3. As noted, the Supreme Court recently upheld this rule in the *O'Hagan* case.

It is too soon to make any intelligent generalizations about how legislation modeled on the Directive has fared jurisprudentially. In the scheme of things, insider trading laws fashioned under the Directive are in their infancy. At the time the Directive was passed, four of the 12 members of the EC – West Germany, Belgium, Italy and Ireland – had no insider trading legislation on the books and the remaining eight members – France, England, Luxembourg, the Netherlands, Denmark, Greece, Portugal and Spain – had widely varying statutes.⁴⁹ Several of the members took time well beyond the 1992 deadline to get legislation in place. Luxembourg,

for example, enacted its version of the Directive just last year.⁵⁰

And, obviously, the statutes are not self-enforcing – getting them on the books is only the first step to effecting a change in practice. Germany and Italy, in particular, have had trouble surmounting cultures which traditionally viewed insider trading as an acceptable practice. One commentator recently observed as to Italy that “[i]n spite of the passage of laws on takeovers and insider trading since 1992, the bourse has not shaken its reputation as a fiefdom of an inward-looking financial community that treats small shareholders shabbily.”⁵¹ By contrast, Chairman Levitt recently observed as to the U.S. markets: “Individual investors think – and I passionately believe – that the proverbial little guy’ on Main Street should have the same fair chance as the big guys.”⁵²

V. Civil vs. Criminal Insider Trading Prohibitions

Although it may be too early to draw conclusions about the efficacy of the EC Directive generally, one aspect bears discussion as we look to the future of insider trading regulation. The Directive leaves it to the discretion of its members to provide appropriate penalties for violations of insider laws, with the proviso that the “penalties shall be sufficient to promote compliance with these measures.”⁵³ A rational assumption is that making insider trading a criminal offense, carrying the threat of imprisonment, provides the greatest deterrent to commission of the offense.

On one level, this is certainly true. Providing stiff criminal penalties for insider trading sends a message to the community that the government considers insider trading to be a serious offense, contrary to attitudes prevailing quite recently in many markets outside the U.S. But if the law does not lead to successful prosecutions, its power as a deterrent is soon diminished.

The experience in the Netherlands is noteworthy. In May of this year, Dutch authorities heralded its new law against insider trading as the “toughest in the world.”⁵⁴ The statute provides for criminal penalties only.

In June of this year, following a two year investigation, Dutch prosecutors began their case against four individuals charged with insider trading in options on shares of a Dutch company.⁵⁵ Prosecutors alleged that one of the defendants, a director of the company, alerted three option traders of price sensitive information in advance of the company’s announcements. The prosecutors based their case on evidence that the defendants met regularly in a restaurant during the relevant time period.⁵⁶ The judges dismissed the case against all of the defendants on the grounds that the evidence was circumstantial, and, therefore, did not satisfy the heavy burden of proof that must be met to support a criminal conviction.⁵⁷ The outcome was reported as the latest in a series of disappointments for Dutch prosecutors, who have made only one insider trading prosecution stick in the last 10 years.⁵⁸

Insider trading is an extraordinarily difficult crime to prove. The underlying act of buying or selling securities is, of course, perfectly legal activity. It is only what is in the mind of the trader that can make this legal activity a prohibited act of insider trading.

Direct evidence of insider trading is rare. There are no smoking guns or physical evidence that can be scientifically linked to a perpetrator. Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial. The investigation of the case and the proof presented to the fact-finder is a matter of putting together pieces of a puzzle. It requires examining inherently innocuous events – meetings in restaurants (as in the Dutch case), telephone calls, relationships between people, trading patterns – and drawing

reasonable inferences based on their timing and surrounding circumstances to lead to the conclusion that the defendant bought or sold stock with the benefit of inside information wrongfully obtained.

This is why providing civil, as well as criminal, liability is vital to an effective insider trading program. While it is possible to prove beyond a reasonable doubt (the standard in a criminal case) that a defendant engaged in insider trading based entirely on circumstantial evidence, it poses significant challenges and, in fact, almost all successful criminal insider trading prosecutions in the United States have rested at least, in part, on the testimony of cooperating witnesses. The burden of proving a purely circumstantial case is less onerous in the civil context, where guilt need be shown only by a preponderance of the evidence, rather than beyond a reasonable doubt, and where the use of presumption may shift the burden of proof to the defendant under certain circumstances. For example, in a civil case, the finder may draw an adverse inference against a defendant who asserts his Fifth Amendment right not to testify.⁵⁹ No such inference may be drawn in a criminal prosecution.⁶⁰

In the United States, insider trading is a crime, punishable by monetary penalties and imprisonment. But it is also a civil offense. The importance of making insider trading both a criminal and civil offense is illustrated by two recent decisions by U.S. federal courts.

In September 1998, the Ninth Circuit Court of Appeals held in the case of *United States v. Smith*⁶¹ that in a criminal insider trading case, the government must prove that even a defendant who is a traditional insider (rather than a misappropriator) actually used material nonpublic information in making the decision to trade, rejecting the SEC's position and the position of the Second Circuit expressed in an earlier decision⁶² that it is enough for the government to show that the defendant was in possession of the information at the time he traded. Several months ago, the Eleventh Circuit Court of Appeals reached the same decision in *SEC v. Adler*, a civil case, but to alleviate the difficulties of proof raised by the standard, adopted a rule providing that although "use" is a required element of a Rule 10b-5 insider trading violation, when an insider trades in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading.⁶³ The burden then shifts to the trader to rebut the inference by adducing evidence that there was no causal connection between the knowledge and the trade. Such an inference is unavailable in the criminal context, where the burden remains on the government to prove each element of an offense beyond a reasonable doubt. These two cases demonstrate the importance of having both civil and criminal prosecution available to the regulator.

In the United States, civil enforcement by the SEC has proved to be an extremely powerful tool against insider trading. The SEC has broad authority to investigate possible violations of the federal securities laws, including insider trading. In its informal investigations, which the staff can conduct without Commission authorization, the staff requests information on a voluntary basis. In its formal investigations, the staff can use the Commission's subpoena power to compel witnesses to testify or to produce books, records, and other evidence.

The federal court injunction, an order that prohibits future violations of the law, has historically been one of the Commission's principal enforcement tools. Conduct that violates the injunction may result in fines or imprisonment. In actions seeking injunctions, the Commission also may request temporary restraining orders and preliminary injunctions as emergency relief to address ongoing violations. In its emergency actions, the Commission will often request freeze orders to prevent profits from alleged insider trading from disappearing pending the investigation and enforcement effort. As additional sanctions in civil actions, the Commission frequently seeks orders requiring disgorgement of illegal profits and the payment of civil

penalties.

In 1984, Congress enacted the Insider Trading Sanctions Act of 1984, to remedy the "inadequate deterrent provided by enforcement remedies for insider trading," observing that an "injunction . . . serves only a remedial function and does not penalize a defendant for the illegal conduct [and] disgorgement . . . merely restores a defendant to his original position without extracting a real penalty for his illegal behavior."⁶⁴ The Act provides for penalties up to three times the profit gained or the loss avoided by the insider trading, providing a powerful deterrent to would-be violators.⁶⁵

The U.K. is following America's lead in an effort to improve its prosecution of insider traders. Although the U.K. was one of the first European countries to enact laws against insider traders, its enforcement record has been disappointing. In the last 18 years, the U.K. has secured only 22 insider trading convictions. Since 1980, the U.K. brought only 17 prosecutions for insider trading, 12 of which were successful.⁶⁶ By contrast, the SEC brought 57 cases alleging insider trading in 1997 alone.⁶⁷ The U.K. system suffered from several problems. Enforcement and regulation powers were spread among separate front-line regulators responsible for particular sectors of the market, overseen by the Securities and Investment Board, whose powers could only be invoked if requested by front-line regulators.⁶⁸ The definition of "insider" was too tightly drawn, allowing insider traders to escape liability if they were once removed from the company whose shares they traded.⁶⁹ Perhaps most significantly, insider trading was only a criminal offense, making successful prosecutions very difficult.⁷⁰

Under new proposals recently announced, enforcement powers will be centralized in U.K.'s Financial Services Administration, which would have far reaching new powers to crack down on insider trading, including the power to impose unlimited civil fines for insider trading. The FSA, modeling itself on the SEC, will have subpoena power, the power to punish noncooperation and to order wrongdoers to make restitution.⁷¹ Hopefully, the U.K. will serve as a model to other countries who are struggling to find ways to effectively deal with insider trading. As the U.S. example has demonstrated, and the U.K. recently recognized, strong civil enforcement powers are an important weapon in the regulator's arsenal.

VI. Cooperation Among International Enforcement Authorities

Insider trading often crosses borders: a foreign national engages in insider trading in the domestic market; nationals effect insider trading through foreign accounts or important evidence of domestic insider trading lies outside domestic borders.

Successful investigations and prosecutions of these cases require international cooperation. Perhaps one of the most progressive aspects of the EC Directive is that it requires members to cooperate with each other "whenever necessary for the purpose of carrying out their duties" in connection with the EC Directive. The significant benefit of this provision is that it requires no further agreements between or among states regarding cooperation.

The SEC has entered into 32 arrangements with foreign counterparts for information sharing and cooperation in the investigation and prosecution of securities law violations. These agreements have taken primarily two forms: Mutual Legal Assistance Treaties in Criminal Matters and Memoranda of Understanding.

The United States has entered into Mutual Legal Assistance Treaties have been entered into with a number of countries, including Switzerland, the United Kingdom and Northern Ireland, the Cayman Islands, the Netherlands, Turkey, Canada, the Bahamas and Italy. The treaties

generally provide for assistance in criminal matters, including assistance in locating witnesses, obtaining statements and testimony of witnesses, production and authentication of business records and service of judicial and administrative documents. The major advantage of these treaties is that they are binding on the parties to the treaty.

The other form of agreement the United States has relied on in the international context is the Memorandum of Understanding. MOUs are non-binding statements of intent between regulators providing for the exchange of information and mutual cooperation. The Commission has entered into MOUs or similar agreements with Switzerland, Japan, the U.K., Brazil, the Canadian Provinces of Ontario, Quebec and British Columbia, Italy, the Netherlands, France, Mexico, Portugal and Germany. Experience has shown that MOUs provide an effective means of obtaining information in securities enforcement and assist in developing a framework for cooperation and improved communication.

Domestically, the United States has passed laws to facilitate its cooperation with foreign governments. The Insider Trading and Securities Fraud Enforcement Act of 1988 expanded the Commission's ability to provide assistance to foreign regulators by allowing it to use its compulsory powers to compel testimony and production of documents obtain information at the request of a foreign securities authority.

The International Securities Enforcement Cooperation Act of 1990 enlarged the Commission's ability to address international securities issues in several ways. It amended the securities laws to permit the Commission to institute an administrative proceeding barring, sanctioning, or otherwise placing conditions on a securities professional's ability to engage in Commission-regulated activities if a foreign court or securities authority has found that the professional engaged in illegal or improper conduct. The law also amended the securities laws to provide confidential treatment for records produced under reciprocal arrangement with foreign securities authorities by exempting the documents from the disclosure obligation of the Freedom of Information Act if a good faith representation is made that disclosure would violate that country's confidentiality requirements. In addition, the law makes explicit the Commission's rulemaking authority to provide access to nonpublic documents and other information to both foreign and domestic authorities. Finally, it authorizes the Commission to accept reimbursement from a foreign securities authority for expenses incurred by the Commission in providing assistance.

In 1997, the SEC made 240 requests to foreign governments for enforcement assistance and responded to 363 requests for enforcement assistance from foreign governments.⁷²

In the summer of 1998, the SEC had a notable success in obtaining information under the Hague Convention, which prescribes certain procedures by which a judicial authority in one contracting state may request evidence located in another contracting state in civil cases.⁷³ In an emergency action filed in the Southern District of New York, the Commission filed a complaint against two Singapore residents, alleging that the defendants engaged in insider trading prior to the public announcement that APL Limited would be acquired by Singapore-based Neptune Orient Lines, Ltd. The court granted the Commission's request for a temporary asset freeze and orders requiring the defendants to identify themselves, allowing expedited discovery, and granting other ancillary relief.⁷⁴

The Commission applied to the High Court of the Republic of Singapore under the Hague Convention for the appointment of an examiner to take evidence from witnesses in Singapore to be used in the proceeding in the Southern District of New York. The Singaporean defendants opposed the appointment of an examiner, arguing that despite the U.S. classification of the

action as civil, violations of Section 10(b) and Rule 10b-5 are penal in nature and, therefore, the Hague Convention does not apply. The Singapore court held for the SEC, finding that an action for an injunction under Section 10(b) and Rule 10b-5 is a civil proceeding according to the law of the United States and the law of Singapore. This decision, if followed in other Hague signatory countries, opens yet another mode of international information-gathering available to the SEC's enforcement program.

VII. Conclusion

The importance of policing insider trading has assumed international significance as overseas regulators attempt to boost the confidence of domestic investors and attract the international investment community. Reports from the international press confirm a proliferation of law-making and regulatory actions within just the last several months in countries across the globe aimed at curbing insider trading. For example, in 1998 alone:

- Hong Kong regulators unveiled new measures to combat insider trading, including the introduction of new electronic surveillance capability;⁷⁵
- Malaysia amended to its securities laws, for the first time giving investors a private right of action against insider traders;⁷⁶
- In its efforts to curb insider trading, the Securities and Exchange Board of India enacted regulations requiring that corporate deals be reported to stock exchanges within 15 minutes of finalizing;⁷⁷
- Vietnam announced a decree establishing its first public securities market, which includes prohibitions on insider trading;⁷⁸
- The government of Egypt announced that it is working on a comprehensive reform of its regulation of the Cairo Stock Exchange, to bring it into line with world standards;⁷⁹
- The Netherlands Securities Board announced that it is launching an investigation into whether the Amsterdam Exchanges have sufficient systems in place to detect and investigate insider trading.⁸⁰

These developments herald a new era of universal recognition that insider trading, in the words of the SEC's Chairman Levitt, "has utterly no place in any fair-minded law-abiding economy."⁸¹

¹ The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for private publication or statement by any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or of the authors' colleagues on the staff of the Commission.

² Testimony of Arthur Levitt Concerning Appropriation for Fiscal Year 1999 Before the Subcommittee on Commerce, Justice, State and Judiciary of the Senate Committee Appropriations, March 19, 1998.

³ Arthur Levitt, A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading, Address Before the "SEC Speaks" Conference, February 27, 1998.

⁴ *Id.*

⁵ Annual Report of the Securities and Exchange Commission to the United States Congress for

Fiscal Year 1997.

⁶ Oliver August, *Insider Dealing Returns Thanks to Merger Mania*, *The Times*, August 17, 1998, Business Section.

⁷ *Strong v. Repide*, 213 U.S. 419 (1909).

⁸ See, e.g., Henry B. Manne, *Insider Trading and the Stock Market* (1966) (insider trading increases market efficiency because it produces desirable incentives on corporate managers).

⁹ E.g., Charles Vaughn Baltic, III, *The Next Step in Insider Trading Regulation: International Cooperative Efforts in the Global Securities Market*, *Law and Policy in International Business*, Vol.23; No.1 at 167; Dennis J. Block and Jonathan M. Hoff, *Renewed Interest in Defining Insider Trading*, *The New York Law Journal*, June 14, 1990, at 5.

¹⁰ *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983).

¹¹ See *supra* note 2.

¹² *Nanny Discovers Abusive Squeezes*, *The Daily Telegraph*, June 30, 1998, at 27.

¹³ *SEC v. Stevens*, 91 Civ. 1869 (S.D.N.Y. March 19, 1991), *Litig. Rel. No.* 12813.

¹⁴ *SEC v. Rosenberg*, 91 Civ. 2403 (D.D.C. September 24, 1991), *Litig. Rel. No.* 12986.

¹⁵ When the U.S. Congress passed the *Insider Trading and Securities Fraud Enforcement Act of 1988*, which augmented the law through a variety of measures designed to provide greater deterrence, detection and punishment of violations of insider trading law, it noted in its report that it "recognizes that market analysts play a crucial role in facilitating the dissemination of information to the marketplace, thereby promoting smoothly functioning markets. The legislation is not intended to interfere with these critical functions." *Insider Trading and Securities Fraud Enforcement Act of 1988*, H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988) (reprinted in 1988 U.S. Code Cong. & Admin, News 6043, 6056).

¹⁶ See *supra* note 2.

¹⁷ See Manne, *supra* note 7; Bruce Fein, *What's So Bad About Insider Trading?*, *The Legal Times*, January 6, 1992, at 18; Henry N. Butler, *Can the SEC Change?*, *Corporate Board*, May 1989, Vol. 10, No. 56, at 6.

¹⁸ One of the authors regularly receives phone calls from angry options writers who may have written hundreds of out-of-the-money contracts on the stock of the target shortly before the public announcement of a tender offer. Several important insider trading cases began with such a call.

¹⁹ James A. Silkenat, *Overview of U.S. Securities Markets and Foreign Issuers*, 17 *Fordham Int'l L.J.* S4 (1994). Regarding Germany, a commentator notes, "What was long appreciated by locals as Frankfurt's cosy, clubby atmosphere is now increasingly seen as unacceptable provincialism, and a serious hindrance to the city's bid to challenge London for the position as Europe's main financial centre." John Eisenhammer, *Red Faces at Failure to Enact EC Law; The Hard Bargaining, High-Living Former Head of Germany's Biggest Union is a Fallen Hero After*

Insider Dealing Scandal, The Independent (London), May 30, 1998, at 13.

²⁰ Council Directive 89/592 Coordinating Regulations on Insider Trading, 1 Common Mkt. Rep. (CCH) ¶ 1761.

²¹ 17 C.F.R. § 240.10b-5.

²² Section 17(a) of the Securities Act of 1933 reaches similar fraud in the initial offering or sale of a security.

²³ 40 SEC 907 (1961).

²⁴ *Id.*

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

²⁶ *Id.* at 851-52.

²⁷ 445 U.S. 222 (1980).

²⁸ The Commission's authority to promulgate rules under Section 14(e) of the Exchange Act is confined to the tender offer context. It reads, in relevant part: "It shall be unlawful for any person . . . to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer The [SEC] shall . . . by rule or regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative." 15 U.S.C. §78n(e).

²⁹ 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir. 1983), cert. denied, 464 U.S. 863 (1983).

³⁰ 463 U.S. 646 (1983).

³¹ 791 F.2d 1024 (2d Cir. 1986), aff'd 484 U.S. 19 (1987).

³² Echoing the Carpenter case, German prosecutors reportedly are considering bringing insider trading charges against a German television journalist, known as "Germany's first international stock market guru," for allegedly telling his friends which stock he was going to recommend on his weekly program. German TV Journalist is Accused of Insider Trading, AP Worldstream, August 17, 1998, financial pages.

³³ 791 F.2d at 1029.

³⁴ 484 U.S. 19, 24 (1987).

³⁵ *Diamond v. Oreamuno*, 248 N.E. 2d 910, 912 (N.Y. 1969).

³⁶ See, e.g., *SEC v. Materia*, 745 F.2d 197, 201 (2d Cir. 1984); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1990); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

³⁷ *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995); *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996).

³⁸ *United States v. O'Hagan*, 117 S.Ct. 2199, 2211 (1997) (quoting the Eighth Circuit's opinion in *O'Hagan*, 92 F.3d at 618).

³⁹ 117 S. Ct. 2199 (1997).

⁴⁰ The Court also rejected O'Hagan's argument that the Commission's Rule 14e-3, which prohibits trading in securities based on nonpublic information about a tender offer (see *supra* note 28 and accompanying text), is invalid because the Commission exceeded its statutory authority in promulgating it.

⁴¹ 117 S. Ct. at 2207.

⁴² 117 S. Ct. at 2210.

⁴³ 117 S. Ct. at 2208.

⁴⁴ Council Directive 89/592 Coordinating Regulations on Insider Trading, 1 Common Mkt. Rep. (CCH) ¶ 1761 ("EC Directive").

⁴⁵ See Warren, *The Regulation of Insider Trading in the European Community*, 48 Wash. & Lee L. Rev. 1037 (1991).

⁴⁶ *Id.* at 1043-44.

⁴⁷ William Dawkins and Hugo Dixon, *EEC Proposes Action on Insider Trading*, *The Financial Times* (London), April 29, 1987, at § I, 48.

⁴⁸ EC Directive, *supra* note 44. Article 11 provides that the EC may enter into agreements with non-member countries on insider trading issues and Article 12 provides for a Contact Committee to deal with problems that may arise under the Directive.

⁴⁹ Tim Dickson, *Ensuring the 1992 Programme Isn't A Spivs' Charter; The European Market*, *Financial Times*, June 19, 1989, § I, at 2.

⁵⁰ *Insider Trading Accord Creates Dual Definitions for Insider*, *Eurowatch, Financial Services*, Vol. 9, No. 16, October 17, 1997.

⁵¹ Robert Graham, *New Broom for Bourse: The Head of Italy's Stock Market Watchdog Outlines His Plans*, *Financial Times* (London Edition), March 24, 1997, at 22.

⁵² Arthur Levitt, *A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Address Before the "SEC Speaks" Conference, February 27, 1998.

⁵³ EC Directive, Art. 13.

⁵⁴ Loudon Clear, *Financial Times* (London), May 20, 1998, at 13.

⁵⁵*BolsWessanen Insider Trading Case Today, Suspects Allegedly Made 700,000 nfl, AFX News, June 2, 1998.*

⁵⁶*BolsWessanen Insider Dealing Charges Dismissed, AFX News, July 17, 1998.*

⁵⁷*Id.*

⁵⁸*BolsWessanen Case Fails, Financial Times (London), July 17, 1998, at 2. See also David McKay, Insider Trading Case Opened After Leak of Sad Document, Business Day (South Africa), September 14, 1998 at 1 ("There has never been a prosecution for insider trading in South Africa. Under present law insider trading is a criminal offense and the burden of proof is extremely onerous.")*

⁵⁹*Baxter v. Palmigiano, 425 U.S. 308, 318 (1976) (holding that Fifth Amendment "does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them."); SEC v. Colello, 139 F.3d 674 (9th Cir. 1998) (applying Baxter to SEC civil enforcement proceedings); SEC v. Graystone Nash, 25 F.3d 187 (3rd Cir. 1994) (same).*

⁶⁰*Griffin v. California, 380 U.S. 609 (1965).*

⁶¹*1998 U.S. App. LEXIS 20750.*

⁶²*See United States v. Teicher, 987 F.2d 112, 119 (2d Cir. 1992), cert. denied, 114 S. Ct. 467 (1998).*

⁶³*137 F.2d 1325 (1998).*

⁶⁴*See SEC v. Downe, 969 F. Supp. 149, 159 (S.D.N.Y. 1997) (quoting H.R. Rep. No.98-355, at 7-8 (1983), reprinted in 1984 U.S.C.C.A.N. 2274, 2280-81).*

⁶⁵*15 U.S.C. § 78u-1.*

⁶⁶*Clare Dobie, Alter Insider Trading Law, Says SIB Chief, The Independent (London), March 26, 1990, at 22.; Jane Martinson, Strong Regulator to Be a Balance by Independent Appeal System; Enforcement A "Consistent Approach" That is Designed to Provide a Level Playing Field, The Financial Times (London), July 31, 1998 at 8.*

⁶⁷*Annual Report of the Securities and Exchange Commission to the United States Congress for Fiscal Year 1997.*

⁶⁸*Bring It All Under One Roof: Personal View of Lord Alexander: There Are Too Many Organizations Involved in the Present System of Financial Regulation, The Financial Times (London), February 28, 1997, at 20.*

⁶⁹*Wrong Track on Insider, The Financial Times (London), September 29, 1992, at 24.*

⁷⁰*Clare Dobie, Alter Insider Trading Law, Says SIB Chief, The Independent (London), March 26, 1990, at 22.*

⁷¹Jane Martinson, *Powers Against Crime Will Reflect SEC's Sanctions*, *The Financial Times* (London), July 31, 1998, at 11.

⁷²See *supra* note 67.

⁷³*The Hague Convention on the Taking of Evidence Abroad in [C]ivil or Commercial Matters*, Mar. 18, 1970, 23 U.S.T. 2555.

⁷⁴*SEC v. One Unknown Purchaser of the Call Options of APL Limited and Ong Congqin Bobby*, 97 Civ. 2664 (S.D.N.Y. April 15, 1997), Litig. Rel. No. 15334.

⁷⁵Stewart Oldfield and Sauw Yim, *Regulators Aim to Hit Market Regulation*, *South China Morning Post*, July 22, 1998, at 1.

⁷⁶Munir: *Amendments to Promote Transparency*, *New Straits Times-Management Times*, June 17, 1998.

⁷⁷*Indian Watchdog Makes Negotiated Deals More Transparent*, *Asia Pulse*, August 13, 1998.

⁷⁸Jonathan Birchall, *Hanoi Decree on Exchange*, *Financial Times*, July 15, 1998.

⁷⁹*Global Regulations: Financial Reforms in Germany, Egypt, Philippines*, *EIU ViewsWire*, April 9, 1998.

⁸⁰*Netherlands Securities Board to Investigate Amsterdam Bourse Systems*, *AFX News*, July 22, 1998.

⁸¹Arthur Levitt, *A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Address Before the "SEC Speaks" Conference, February 27, 1998.

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