

INSIDE INFORMATION AND SECURITIES TRADING



***A LEGAL AND ECONOMIC ANALYSIS
OF THE FOUNDATIONS OF
LIABILITY IN THE
USA AND EUROPEAN COMMUNITY***



BERNHARD BERGMANS

Graham & Trotman

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in the U.S.A. and the European Community**

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A member of Wolters Kluwer Academic Publishers

LONDON/DORDRECHT/BOSTON

Graham & Trotman Limited
Sterling House
66 Wilton Road
London SW1V 1DE
UK

Kluwer Academic Publishers Group
101 Philip Drive
Assinippi Park
Norwell, MA 02061
USA

© Graham & Trotman, 1991

First published in 1991

British Library Cataloguing in Publication Data

Bergmans, Bernhard

Inside information and securities trading: a legal
and economic analysis of the foundations of liability.

I. Title

332.65

ISBN 1-85333-569-X

Library of Congress Cataloging-in-Publication Data

Bergmans, Bernhard.

Inside information and securities trading: a legal and economic
analysis of the foundations of liability / Bernhard Bergmans.

p. cm.

Includes bibliographical references (p.).

ISBN 1-85333-569-X

1. Insider trading in securities—Law and legislation—United
States. 2. Liability (Law)—United States. 3. Insider trading in
securities—Law and legislation—European Economic Community
countries. 4. Liability (Law)—European Economic Community
countries. I. Title.

K1115.L57B47 1991

346'.092—dc20

[342.692]

91-28961

CIP

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Printed and bound in Great Britain by Hartnolls Ltd, Bodmin, Cornwall

CONTENTS

INTRODUCTION	1
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PART 1 - LAW

Subpart 1 - U.S.A.

Chapter I. DEVELOPMENT OF THE LAW OF »INSIDER TRADING«

<i>A.- Common law</i>	7
<i>B.- Federal securities regulation</i>	9
<i>C.- Case law development</i>	10
1. Origin	10
2. Expansion	11
3. The »information approach« and its rejection in favor of a »fiduciary duty approach«	12
4. The »misappropriation approach«	13
<i>D.- Other sources of liability</i>	14
<i>E.- Congressional reactions</i>	15

Chapter II. PRESENT LEGAL SITUATION

<i>A.- Common elements of »insider trading«</i>	17
1. Trading in securities	17
2. Material information	19
3. Nonpublic information	19
<i>B.- General basis of liability: section 10(b) and rule 10b-5</i>	20
1. The »fiduciary duty approach«	21
2. The »misappropriation approach«	23
<i>C.- Elements of cause of action under section 10(b) and rule 10b-5</i>	25
1. Connection with the purchase or sale of securities	26
2. Scierter	26
3. Materiality	27

<i>D.- Enforcement of the »insider trading« prohibition</i>	27
1. Government action	28
2. Private rights of action	29
<i>E.- Other federal sources of liability</i>	33
1. Section 17(a) of the Securities Act of 1933	33
2. Section 16(b) of the Exchange Act of 1934	33
3. Rule 14e-3	35
4. Mail and wire fraud	36
5. RICO	37
<i>F.- Liability under state corporation law</i>	38

Chapter III. ANALYSIS

<i>A.- Introduction</i>	41
1. Evolution and diversification of the law of »insider trading«	41
2. Implications	42
3. Future prospects	42
<i>B.- The deficiencies of the fraud and duty analysis under section 10(b) and rule 10b-5</i>	43
1. The deception or fraud requirement	43
2. The duty to disclose (or abstain)	44
3. The »information approach«	45
(a) Fraud	45
(b) Source and scope of the duty	46
4. The »fiduciary duty approach«	47
(a) Fraud and fiduciary duty	47
(b) Source and nature of the duty	49
5. The »misappropriation approach«	51
(a) Fraud and misappropriation	51
(b) Source of the duty	54
<i>C.- Consequences</i>	55
1. Problems of scope	56
(a) The »information approach«	56
(b) The »fiduciary duty approach«	57
(c) The »misappropriation approach«	59
2. The ambiguities of the duty to disclose or abstain	61
3. Interpretation of section 10(b) and rule 10b-5	62
<i>D.- Conclusion</i>	64

Subpart 2 - EUROPEAN COMMUNITY**Chapter I. THE EUROPEAN INSIDER DEALING DIRECTIVE**

<i>A.- Historical development</i>	67
<i>B.- Elements of »insider-dealing«</i>	69
1. Insiders	69
(a) Primary insiders	69
(b) Secondary insiders	71
2. Inside information	71
(a) Status	72
(b) Nature	72
(c) Contents	73
(d) Source	73
3. Transferable securities	73
<i>C.- Prohibitions</i>	74
1. Dealing	74
(a) Principle	74
(b) Restrictions	75
2. Tipping	75
<i>D.- Penalties</i>	76
<i>E.- Enforcement</i>	77

Chapter II. ANALYSIS

<i>A.- The need for a harmonized regulation</i>	79
1. The need for regulation	79
(a) Frequency of »insider dealing«	79
(b) Policy arguments	80
(c) Voluntary restraints and/or self-regulation	80
2. The need for harmonization	82
<i>B.- Implementation</i>	83
1. Elements of »insider dealing«	84
(a) Inside information and transferable securities	84
(b) Insiders	84
2. Prohibitions	87
(a) Dealing	87
(b) Tipping	87

3. Remedies and sanctions	88
(a) Necessity and adequacy of specific criminal sanctions	89
(b) Common law alternatives	90
(c) Final solution	90
4. Enforcement	92
<i>C.- Final appreciation</i>	92
1. Foundations of liability	93
2. Policy	94
3. Conclusion	95

PART 2 - POLICY

INTRODUCTION

1. Law and lawyers	99
2. Economics and economists	100
3. An integrated approach	100

Chapter I. THE (DE-)REGULATION DEBATE

<i>A.- The working of the securities market</i>	103
1. Disclosure and availability of information	104
2. Informational efficiency	105
3. Allocational efficiency	108
4. Operational efficiency	109
5. Unfairness, equality of information and the integrity of the securities market	110
<i>B.- The protection of the interests of particular market participants</i>	114
1. Investors	115
(a) Economic harm	115
(b) Unfairness and equality of return	118
2. Issuers of securities	119
(a) Cost of capital	119
(b) Agency costs	120
(c) Internal efficiency	123
(d) Entrepreneurial compensation and incentive	124
3. Other market participants	127
(a) Market assistants and intermediaries	127
(b) Market auxiliaries or outside agents	128

Chapter II. THE FREE-MARKET ALTERNATIVE

<i>A.- The general setting</i>	131
1. Information and securities markets	131
2. Inside information and »insider trading«	133
<i>B.- The role of property rights and contracts</i>	134
1. Property rights	134
2. Coase theorem	135
<i>C.- Initial allocation of property rights in inside information</i>	136
1. (Inside) Information as a property interest	136
2. Initial allocation	137
<i>D.- Reallocation of property rights</i>	138
1. Introduction	138
2. Intrafirm allocation	139
(a) Principles	139
(b) Criteria	140
(c) Mechanism	140
(d) Internal and external reallocation	142
3. Market reallocation	142
<i>E.- Enforcement</i>	143
1. Ineffectiveness and costliness of administrative enforcement	143
2. Private enforcement	144
3. Administrative enforcement on demand	146
4. Modalities	146
<i>F.- The case against general regulations</i>	147
1. The absence of demand	147
2. A misconceived protection	148
3. The »regulators« as major beneficiaries	149

Chapter III. EVALUATION

<i>A.- Some thoughts about thinking</i>	151
<i>B.- The regulatory approach</i>	153
1. The goal(s) of the »disclose-or-abstain« rule	153
2. The justification for a regulatory intervention	154
<i>C.- The free-market approach</i>	155
1. Introduction	155
2. The relevance of the demand for a prohibition	155
3. Assumptions	156
4. Implications	159

<i>D.- Ethics as a source of securities laws?</i>	160
1. Introduction	160
2. »Insider trading« as an immoral act	160
3. The irrelevance of ethics	161
4. Appreciation	162
(a) Introduction	162
(b) Is »insider trading« immoral?	163
(c) Is regulation justified?	164
(d) Conclusion	165
<i>E.- Unfairness and distribution of wealth</i>	165
1. Introduction	165
2. Fairness as just reward for efforts	166
3. Fairness as distributive justice	168
(a) Introduction	168
(b) Distributive effects of »insider trading«	168
(c) Fairness implications	169
<i>F.- Final observations</i>	170
1. What type of justification is necessary?	170
2. Is regulation justified?	171

PART 3 - A NEW APPROACH

Chapter I. THE INTEGRATED BALANCING APPROACH

<i>A.- General framework</i>	175
1. The meaning of »regulation«	175
2. Justifications for regulation	176
3. The integrated balancing approach	177
<i>B.- The meaning of »insider trading«</i>	178
1. Introduction	178
2. The economic approach	178
3. The legal approach	179
(a) Insider	179
(b) Trading	180
(c) Securities	180
4. Information as the central concept	181
<i>C.- The special nature of »information«</i>	182
1. Information as a public good	182
2. Information as a private good	184
3. Balancing the arguments	184

Chapter II. IMPLEMENTATION

<i>A.- The law of »insider trading« as a part of information law</i>	187
1. Introduction	187
2. Persons and information	188
3. The two components of information law	189
4. Final remarks	189
<i>B.- The rights in (inside) information</i>	190
1. Source and nature of the rights in information	190
2. Determination of ownership of rights	191
3. Contents of the rights	192
4. Criminal liability and sanctions	193
5. Civil liability and remedies	194
(a) Source of liability	194
(b) Standing	194
(c) Calculation of damages	195
<i>C.- The rights to (inside) information</i>	196
1. Meaning and justification	196
2. Types of intervention	197
3. Categories of intervention	197
(a) Creation and dissemination of information	197
(b) Use of information	198
(c) Contents of information	198
<i>D.- Conformity with securities law</i>	199
1. Foundations of liability in the U.S.A.	199
(a) Fundamental conception	199
(b) The »misappropriation« approach and rights in information	200
(c) The »fiduciary duty approach« and rights to information	200
2. Foundations of liability in the EC	201
3. The prohibition	202
4. Enforcement and sanctions	203

CONCLUSION	205
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SELECTED BIBLIOGRAPHY	209
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INTRODUCTION



»Thou shalt not trade in securities on the basis of material nonpublic information!«

This commandment seems to be the guiding principle and the fundamental basis of the legislative, administrative and judicial efforts in the U.S. to curtail »insider trading«¹ and to punish those who do not follow the rule. Enforcement activities and the resulting sanctions have attained a degree of intensity never achieved before. In spite of this, it is not clear what the foundations for the prohibition of such trading are. There is no statutory provision allowing the imposition of liability on such a broad scale as it is done today. And if one would expect this lack of express basis to be explained and compensated by a unanimous attitude as to the policy justification for the unlawfulness of »insider trading«, the criticism of the prevailing attitude in a large part of the economics literature shows that this assumption does not hold either.

Yet, the phenomenon seems important enough for society to attract the attention of the news media. This may be a simple reflection of the increased aggressiveness of the enforcement authorities, which in turn raises the question why government priorities are given to this practice, since it is certainly not new. Indeed, »insider trading« in commodities has been a profitable business since ancient times. And the first (alleged) »insider trading« in securities occurred in 1814 when the Rothschilds are said to have considerably increased their wealth by »insider trading« because they learned about Wellington's victory over Napoleon in Waterloo before the rest of the »city« of London.

Of course, opportunities for profitable trading have dramatically increased since then, and even in the last decade new situations allowing »insider trading« have arisen. This may be the simple reason why the authorities feel that they need to keep this practice within reasonable bounds. Whatever the actual motivation for the present attention given to the phenomenon may be, it is necessary to find a rational and explicit basis for a liability rule whose breadth and vagueness hardly fulfill the requirements of elementary justice.

In Europe, things have evolved differently. Although the awareness of the phenomenon grew parallel to the U.S., the efforts undertaken to tackle the problem were at first very modest and reflected only in stock exchange rules. Even in those few countries that introduced legal prohibitions later on, the statutes were rarely applied and exerted little influence.

¹ The terms »insider trading« and »insider dealing« will be used with quotation marks throughout this book. The reason therefor will be given in Chapter I of Part 3.

It is only during the last decade that existing legislation has been strengthened and new prohibitions been introduced by other States. This was partly the result of the ongoing activities of the Commission of the European Communities which finally resulted in 1989 in the European Insider Dealing Directive setting a common standard for »insider dealing« liability in the EC Member States, which must take measures to comply with the Directive before June 1992.

Despite the creation of this legal basis of liability, the question of its foundation has only been examined superficially. And although there have been controversies as to the personal scope of the prohibition, there have surprisingly been no discussions about policy aspects. The resulting lack of explicit justification will become particularly clear when the broad concepts used in the Directive will have to be interpreted.

In addition, it is up to the Member States to determine the remedies and sanctions for violations of the prohibition. These should logically be in conformity with the rest of the legal system as to their configuration and intensity, and therefore they need an explanation of the basis of the liability imposed in order to determine an adequate penalty, which must not necessarily be identical in all cases.

Both cases, the American as well as the European, reflect the necessity of a thorough (re)examination of the foundations of liability in order to find clear guidelines for future judicial, administrative or even legislative action. This inquiry will start with an analysis of the present U.S. and E.C. law in order to determine its essence and to show the deficiencies of this legal situation (Part 1).

The search for a viable alternative must necessarily start with a careful examination of all policy issues, from ethics to economics, involved in the evaluation of the desirability of trading in securities on the basis of nonpublic material information (Part 2).

The results obtained through this double analysis form the basis for the proposal of a new approach which will give a rational and workable foundation for the regulation of »insider trading« (Part 3).

PART 1

LAW

In this part, the essential elements of the present legal situation and its historical origin will first be outlined and then be analyzed with respect to the foundations of liability. The objective is to give a correct understanding of the law and to identify the deficiencies in the current legal approaches to justify the imposition of liability for »insider trading«.

Subpart 1 will cover essentially U.S. federal law, subpart 2 the law as it will result from the EC Insider Dealing Directive.

Subpart 1

U.S.A.

The law of »insider trading« in the U.S. in its present form can only be correctly understood if its historical development and common law background is taken into account (chapter I).

Chapter II will give a concise presentation of the present status of the law, particularly with respect to the question of the determination of liability.

Finally, the critical analysis in chapter III will show the deficiencies of the present approaches and identify the underlying reasons.

Chapter I

DEVELOPMENT OF THE LAW OF »INSIDER TRADING«

A.- COMMON LAW¹

Prior to the enactment of federal securities laws, a party to a business transaction was protected only from material misrepresentations and misleading half truths of the other party on which he had relied to his detriment. There was no remedy for damage resulting from the other party's silence about material facts unless there

¹ See e.g. L. LOSS, *Fundamentals of securities regulation* (Little, Brown & Co, Boston 1988), p.723-25; 3A W. FLETCHER, *Cyclopedia of the law of private corporations* (1986 perm.ed.), § 1168-1171; M. CONANT, Duties of disclosure of corporate insiders who purchase shares, 46 *Cornell L.Q.* 53 (1960).