INSIDE INFORMATION AND SECURITIES TRADING

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

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Graham & Trotman

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Graham & Trotman
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

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.I57B47 1991
346′.092—dc20
[342.692] 91-28961
CIP

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

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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.

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[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 LAW[1]

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).