

Insider Trading: An Economic and Legal Problem

How would *O'Hagan* Come Out Under the New German Securities Trading Act?*

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ⁱ Introduction and Description of the Problem

Insider trading arises in securities transactions when one party possesses nonpublic information. Although insider trading clearly is not a recent phenomenon in the business world, legal as well as economic discussions about it still continue. According to Bergmans,ⁱⁱ the first insider trading case allegedly arose when the Rothschilds benefited from insider trading when they learned of Wellington's victory in Waterloo earlier than the rest of London.ⁱⁱⁱ During the great takeover battles in the 1980s, several insider scandals shocked the corporate world in the United States (U.S.).^{iv} The cases of Ivan Boesky and Dennis Levine, Michael Milken and Martin Siegel provide poignant examples of the significance and dimension of insider trading.^v However, insider trading did not end in the 1980s and remains an issue in the 1990s. In 1993, a former Goldman Sachs executive agreed to disgorge \$1.1 million that he had received as profits deriving from insider transactions.^{vi} Only recently, in June 1997, the Supreme Court decided the

O'Hagan case and approved the validity of the misappropriation theory, giving a clear signal to the capital market.^{vii} The U.S. Supreme Court overturned the Court of Appeals of the Eighth Circuit, which did not hold a lawyer liable who profited from insider transactions.^{viii} Despite the long history of insider trading in the United States and this recent development, many unsolved issues remain.

Both legal and economic scholars still debate whether insider trading should be regulated at all. However, even if this question is answered affirmatively, legal scholars as well as judges in the different circuits discuss the applicable legal theory of liability. The U.S. Supreme Court was given another chance to shed light on the dark side of insider trading. *O'Hagan* will clearly resolve the chaos regarding insider trading regulations. The Supreme Court's ruling will have tremendous consequences for the treatment of nontraditional insiders, such as directors, managers, and officers, who are outside the corporation in which they possess nonpublic information.^{ix} Thus, insider trading is not merely an issue for legal history. It is still a current legal problem.

An international observation reveals that insider trading regulation has a world-wide dimension in the age of global financial markets.^x The European Community also dealt with the problem and forced its member states to implement a mandatory prohibition against insider trading.^{xi} In 1994, even Germany, which had previously refused to consider regulation, enacted a law prohibiting insider trading.^{xii}

This thesis will argue that trading on the basis of nonpublic material information should be regulated, and not left to free market forces. It will then compare insider trading regulation in the United States and Germany. Concerning U.S. law it will mainly describe which persons are liable as insiders when trading in securities on the basis of nonpublic information. Then, the thesis will take a closer look at the insider trading provisions of the recently enacted German Securities Trading Act and presenting the key elements of it. Finally, it will show that there are differences between the two systems regarding liability. The thesis will describe these differences by evaluating the recently decided U.S. insider trading case from a German perspective.

Part 1: Demand For Regulation of the Insider Problem

Purpose of the chapter

It is not clear whether trading in securities on the basis of nonpublic information requires regulation. This discussion still continues between legal and economic scholars. Henry Manne's "provocative little"^{xiii} book *Insider Trading and the Stock Market* evoked scepticism and controversy about regulation some thirty years ago.^{xiv} He reaches the general conclusion that insider trading is beneficial to the firm, the market and society, and, therefore requires no regulation. Manne's statements started the insider discussion in the United States. More recently, the issue has achieved global proportions.^{xv} However, a consensus between regulators and deregulators is almost impossible.^{xvi} This chapter will present the most relevant arguments. A personal evaluation will follow the different arguments. Before discussing the regulation in detail, the case for it should be made.

With the immense volume of literature and variety of approaches proposed since Manne, this thesis requires some focus. Therefore, this paper will focus on:

I. the impact of insider trading on a company and its operations, describing and evaluating compensation and incentives arguments,

II. the marketplace impact regarding informational, allocational and operational efficiency,

III. the issue of fairness, and finally

IV. the issue of harm to individual investors.

I. The Impact on a Company and its Operations

1. Insider trading as the most appropriate form of compensation providing incentives for managers

a) Deregulators' arguments:

(1) Incentives

Deregulators argue that insider trading is an efficient form of compensation, providing incentives for management to act in the firm's best interest. Insider trading, they say, encourages entrepreneurship.^{xvii} According to Manne, the separation of ownership and control in modern corporations^{xviii} requires the establishment of management incentives.^{xix} While the classic entrepreneur reaps the full benefit of innovation, a corporation's shareholders, not management, enjoy the success of innovation. Therefore, motivating managers towards innovation, requires the creation of incentives. Only insider trading, Manne argues, can overcome the bureaucracy of firms caused by the separation of ownership and control. Furthermore, insider trading supposedly fosters innovative conduct.^{xx} The significance Manne attributes to unregulated insider trading becomes obvious in his conclusion: "A rule allowing insiders to trade freely may be fundamental to the survival of our corporate system. People pressing for the rule barring insider trading may inadvertently be tampering with one of the wellsprings of American prosperity." ^{xxi}

(2) Reduction of agency costs

Deregulators claim that unregulated insider trading reduces agency costs.^{xxii} Agency costs arise from the separation of ownership and control because the agent's self-interest and the pursuit of the principal's interest are not congruent.^{xxiii} Agency costs also result from negotiations about the management compensation. Carlton and Fischel believe that, without insider trading, permanent renegotiation about the manager's compensation is required.^{xxiv} These costly renegotiations become unnecessary, because managers design their own compensation packages every time they trade. Therefore, managers seek and

develop news on which they can trade and earn profits. Using this argument, deregulators claim that "insider trading may present a solution to this cost-of-renegotiating dilemma."^{xxv} The use of insider information is compared with the use of patents. The benefits of good performance belong to the manager as the innovator receives the benefits in the form of royalties from his innovation.^{xxvi}

Insider trading supposedly not only reduces agency costs by minimizing renegotiations, it also decreases agency costs by minimizing the costs of screening of capable managers, by reducing monitoring costs caused by risk-averse managers, and avoiding opportunity costs caused by suboptimal investment decisions.^{xxvii} Risk aversion arises in managers because of their concern for job security.^{xxviii} Since compensation depends on the creation of valuable information, insider trading rewards superior managers better than inferior ones. Managers who favor risky projects prefer insider trading as a form of compensation, because it favors them more than risk-averse managers. Thus, insider trading is supposedly a more certain reward than other available forms of compensation, and provides more incentives.^{xxix}

(3) The Coase Theorem

Deregulators rely upon the Coase theorem. This theorem states that, in a world without transaction costs and uncertainty, privately negotiated agreements will allocate resources to their most valuable use.^{xxx} It does not matter at what point the law initially allocates a property right since the parties will reallocate it to the user to whom it has the greatest value. Private negotiations will, in the absence of interference by the government, provide the best allocation of private rights. Easterbrook and Fischel argue that "[t]he Coase theorem implies that firms and insiders have strong incentives to allocate the property right in valuable information to the highest valuing user."^{xxxi} Regulators, however, state that the Coase theorem is not applicable in this situation.^{xxxii} Negotiations between managers and shareholders do incur transaction costs. Furthermore, information has the same value for outsiders and insiders.

Regulators also point out that the negotiated result between the firm and the shareholders could affect other firms and nonshareholders. Consequently, the application of the Coase theorem seems problematic because it assumes that the affected parties are the negotiating parties.^{xxxiii} Therefore, in my opinion, the Coase theorem does not support arguments against regulation.

b) Regulators' arguments regarding compensation

Generally, regulators question deregulators' fundamental arguments. Regulators claim that there is virtually no empirical evidence indicating insider trading as the most efficient and most accurate form of compensation.^{xxxiv} Regulators argue that the financial ability to purchase stock limits a manager's compensation. Therefore, compensation depends not primarily on the value of the information or on the value of the contribution to the information, but rather on wealth.^{xxxv} Thus, managers' abilities to tailor their own compensation packages is limited.^{xxxvi} Manne's response that insider trading guarantees a

particular form of compensation, but not a particular amount,^{xxxvii} reveals that even he questions the accuracy of insider trading as a form of compensation. This argument put forward by regulators as a direct response to Manne's "provocative" book, is no longer true in today's securities markets. Today, stock option contracts enable investors to profit by investing only a small amount of capital. Option contracts "combine relatively small initial investments with a substantial potential for gain and loss."^{xxxviii} Therefore, it is clear why insiders in the 1980s used call options to gain profits with relatively small capital.^{xxxix}

Additionally, regulators claim that the compensation depends completely on external factors such as the structure of the capital market, the level of the firm-specific risk and the average amount of outsider sales per period.^{xl} Furthermore, it cannot be assured that only the producer of the valuable information will be the one who will exploit the information.^{xli} The manager creating positive news is not the only one who might benefit from it. This leads to a free-rider problem in the case of unregulated insider trading. If a manager wants to exploit information, he must withhold it from colleagues until after his stock transactions. Profitable insider trading requires that the number of insiders with privileged information is small.^{xlii} With an increasing number of insiders within the company, competition might nullify gains from insider trading.^{xliii} In this case, insider trading delays the flow of information.^{xliv} These delays cause significant costs to the firm.^{xlv} When transmission of information within the firm is delayed, the decision making in the firm can potentially be hampered and cause injury to the firm.

Regulators additionally question whether managers would choose insider trading as a form of compensation. They suggest that even managers may prefer more certain compensation over the uncertain nature of insider trading.^{xlvi}

Scott^{xlvii} and Easterbrook^{xlviii} assert that insider trading reduces the wealth of a firm by making performance-based compensation of managers even more difficult. Benefits from insider trading depend on many factors and cannot be anticipated with any certainty. Easterbrook compares insider trading to the purchasing of a lottery ticket.^{xlix} I think this comparison is very illustrative, showing the unpredictable nature of insider trading, and showing that insider trading is not performance-based.

Regulators, however, contribute more to the debate than merely questioning insider trading as an ideal form of compensation. Regulators strongly believe that a compensation scheme based on stock options avoids the disadvantages of insider trading. Options allow managers to participate in the firm's success.^l Active participation in the firm through options could affect the manager's efforts more positively than the allowance of insider trading.

2. Conflict of interests

Regulators also argue that insider trading leads to a conflict of interests between a firm and its management.^{li} They believe that insider trading may harm the firm since it motivates insider managers differently than profit-maximizing managers. An insider

manager may not work in the firm's best interest.^{lii} While the profit-maximizing-manager constantly maximizes the difference between costs and returns, the insider trading manager is interested only in maximizing the profit in good periods, but may neglect costs in bad periods.^{liii} Two examples can illustrate this conflict of interest more closely: The incentives to undertake overly risky projects and the behavior in context of takeovers.

3. Incentives to undertake overly risky projects

The theory underlying insider trading as compensation asserts that the manager benefits from the change in the stock price since he buys or sells before the trading public has received knowledge. Therefore, insider managers undertake suboptimal risks.^{liv} Insiders may select very risky projects promising an increased volatility in stock prices, thereby giving them greater opportunity to profit from insider trading.^{lv} The insider will not select projects promising the highest return for the firm, but rather projects promising increased volatility in stock prices. The higher the project's risk is, the higher the stock's volatility. Manager's aims and firm's aims are therefore not aligned.

Insider trading is also inappropriate compensation if insiders can purchase options for fraction of the stock's value. While managers will admittedly profit if the stock price increases, they lose almost nothing if the stock price does not increase. Thus, their incentive is not to maximize firm value, but to maximize risk and volatility, producing the highest possible return for options' purchases.

However, Carlton and Fischel^{lvi} believe that colleagues monitor one another and that managers have strong incentives to maximize the value of their services to the firm. The monitoring argument is well founded.^{lvii} The argument about service-value maximization is less persuasive. Actually, tender offers are a practical method of removing incapable management within the market for corporate control. Management, therefore, should have a strong incentive to perform well and maintain the value of the firm if there is an efficient market of corporate control. If management does not perform well and the stock price decreases, shareholders may sell to a bidder who will oust the incumbents. However, currently the market for corporate control is not efficient and the possibility of management defensive tactics, and federal, and state regulation makes it virtually impossible to remove incumbent management without its consent.^{lviii}

Another reason that manager's and firm's aims are incongruent is that the planning horizons of chief executive officers and their firms are different. Most chief executives reach these positions at a mature age. Most are protected by "golden parachutes" in the event that they leave, or become forced out of their offices. As a result, economic incentives are no different when information lowers firm value than when it raises firm value.^{lix} Therefore, there is virtually no reason for the management to abstain from high-risk projects.

4. Negative effects on the firm in the context of takeovers

Insider trading may also harm the corporation in takeovers situations. Insiders may pursue their personal interests rather than those of the firm or shareholders. If managers of the corporation, trying to take over another corporation, use their knowledge to engage in transactions in the stock of the target corporation, the stock price of the target corporation will increase. Thus, insider trading may increase the costs of the transaction to the aggressor.

One not only faces the problem that insider trading increases the costs of a takeover, but also that managers may consider the possible profit from insider trading, rather than the benefits the acquisition may contribute to the firm's wealth.^{lx} A target corporation's manager might use this knowledge to make the takeover more difficult in order to maintain his job. This can be achieved by driving up the stock price of the target corporation. Therefore, insider trading can also have negative effects regarding control and monitoring of the management.^{lxi}

Summary of the "compensation arguments"

According to regulators, profits from insider trading bear no relation to the insider's contribution to the firm's performance. The aims of managers and their firms are not necessarily identical. Therefore, insider trading is not more beneficial to the company than other compensation schemes. With unregulated insider trading as a form of compensation, it is neither possible for the shareholders to determine in advance how much they will actually pay for managerial services, nor to make cost-effective choices on how to run the firm.^{lxii}

Regulators argue that allowing insider trading will likely increase both opportunity costs and agency costs. Agency costs increase because of the described conflict of interests. Opportunity costs will increase, because it is likely that managers will spend most of their time trying to profit from their own insider transactions.^{lxiii} Separation of ownership and control allows managers to behave more opportunistically. Thus, a conflict of interests arises when managers work in their own interests and not in that of shareholders.

5. Benefiting from good and from bad news (perverse incentives)

As discussed already, an unregulated insider trader may delay the transmission of information to gain from his knowledge. Furthermore, it can lead to a problem of "perverse incentives." This problem arises when managers are not compensated for their performance but for their access to material information.^{lxiv} Insider trading enables managers to benefit from good and bad news.^{lxv} While managers obviously profit from good news, further explanation is required on how they may benefit from bad news.

In the case of bad news, insiders can benefit by short selling. An investor engages in short selling by selling stocks he does not actually own. He borrows stock about which he possesses bad news, and promises to pay back the same number of shares at a later date. The investor then sells the borrowed stock at the current market price. As a result of the bad news being made public, the price will decrease. The investor purchases stocks at the

lower price to replace the borrowed stocks. The profit is the difference between the price at which he sold the stock and the price at which it is repurchased.^{lxvi}

Insiders can also benefit from purchasing put or call options. Put options are options to sell a certain stock at a fixed price for a limited period of time.^{lxvii} Call options are options to buy a certain stock at a fixed price for a limited period of time.^{lxviii} Therefore, the insider manager can preserve his interest through these financial instruments even in bad times.^{lxix} The manager may be tempted to manipulate corporate events or even produce bad news from which he may also benefit. Consequently, one must face the possibility of overproduction of bad news, because bad news is easier to produce than good news.^{lxx}

6. Insider trading as a compensation for controlling shareholders

Demsetz not only focuses on the managers' compensation, but also states that insider trading may function as a compensation scheme for controlling shareholders.^{lxxi} He argues that insider trading is necessary in the interest of the firm, since it is an efficient form of compensation for controlling shareholders.^{lxxii} According to Demsetz, controlling shareholders must hold a large number of shares to control the corporation. As a result, controlling shareholders do not diversify their assets if they only hold stocks of one particular corporation, and therefore, assume high risks. Thus, Demsetz believes that profits from insider trading should be seen as compensation for the costs and disadvantages these controlling shareholders assume because of the lack of portfolio diversification.^{lxxiii}

Demsetz's theory has not received any attention in the insider trading debate.^{lxxiv} Other authors question the relevance of Demsetz's hypothesis, arguing that a shareholders' influence in controlling a corporation is unclear.^{lxxv} Therefore, the compensation argument regarding controlling shareholders is not a strong argument to deny regulation.

7. Evaluation and conclusion of the compensation arguments regarding effects of insider trading within the corporation

I believe that the deregulators' arguments regarding compensation are unconvincing. It is, without any doubt, correct that managers need incentives to perform optimally. However, benefits from insider trading are not related to a firm's success. A manager can realize gains from insider transactions, whether or not he truly acted in the firm's interest. If one takes into account that managers can also benefit from bad news - which may be easier to create - it becomes apparent that insider trading cannot be an appropriate incentive to do a good job for the firm. Thus, I do not agree with the deregulators' argument that insider trading will induce managers to produce good news.

The problem regarding compensation is that the performance of managers can hardly be evaluated *ex ante*. The appropriate compensation can only be set if the performance has paid off.^{lxxvi} In my opinion, one should rather follow the suggestions of regulators and choose a compensation based on the manager's contribution to the firm's performance.

The possibility to benefit from good and bad news also encourages managers to manipulate information. Furthermore, it may lead to a conflict of interests, which, indeed, may harm the firm. Therefore, the ideal compensation would correctly align a manager's performance and hard work with the interest of the firm.

A compensation linked directly to the firm's return also provides incentives for managers to maximize the wealth and growth of the firm. A compensation model based on a connection between the stock price and the manager's reward is also a valid alternative to encourage managers. Clearly, compensation plans do exist which provide incentives without exhibiting the negative effects of insider trading.

Furthermore, the deregulators' compensation arguments are not correct in the case of eavesdroppers, such as people who accidentally receive knowledge of inside information, *e.g.*, by overhearing a conversation between two managers in a restaurant. Compensation arguments also do not apply to tippees. These examples illustrate that there is no connection between insiders' benefits and the firms' wealth.

It is noteworthy that most insider trading cases involve market professionals, *i.e.*, people outside the corporation, such as investment bankers, arbitrageurs, and corporate lawyers rather than the corporate insider Manne addressed by his incentive arguments. Clearly, the compensation argument does not apply to market insiders.

Finally, I deny the deregulators' argument that insider trading reveals the qualification and success of managers. Since insider trading is a form of compensation not tied to good management performance, it does not lead to an effective monitoring mechanism of the management.

While the first subchapter focused on effects of insider trading within the firm, evaluating mainly principal-agent arguments, it did not take into account effects on the capital market. In other words, it was only an isolated observation.^{lxxvii} Therefore, it is premature to reach a clear conclusion at this stage. The next subchapter presents the chief effects of insider trading on the capital market.

II. The Impact of Insider Trading on the Capital Market

The capital market fulfils two functions. First, "it provide[s] companies with capital and investors with shares."^{lxxviii} Second, it channels funds to the most desirable, most profitable uses.^{lxxix}

1. Effects on the marketplace: Informational (a), Allocational (b), and Operational Efficiency (c)

(a) Informational Allocation

Informational efficiency describes "the use of available information to assess securities and securities prices."^{lxxx} An understanding of the effect of insider trading on market

efficiency requires a brief look at the basic market theory called the Efficient Capital Market Hypothesis. The Efficient Capital Market Hypothesis states that stock prices reflect the value of the underlying shares based on all public information about the stock.^{lxxxii} There are three different categories of the Efficient Capital Market Hypothesis. These three different categories are the weak form, the strong form and the semistrong form of the Efficient Capital Market Hypothesis:

i. The Weak Form:

The weak form of the Efficient Capital Market Hypothesis assumes that "prices fully reflect all information contained in the historical pattern of market prices."^{lxxxii} Therefore, no investor can predict future prices by looking at the past development of prices. The weak form implies that prices follow a random walk.^{lxxxiii} Consequently, no advantage arises from studying past prices. The weak form of the Efficient Market Theory is irrelevant in the context of insider trading, because insiders base investment decisions on material nonpublic information and not on pricing patterns.^{lxxxiv}

ii. The Strong Form:

The strong form of the Efficient Capital Market Hypothesis states that securities prices reflect both nonpublic and public information.^{lxxxv} While nonpublic information is only available to corporate insiders, public information is all information, which is generally available to investors through disclosures, formal or informal. Assuming the strong form of the Efficient Market Theory applies, an investor derives no advantages from insider trading, since the information is already incorporated in the price of the stock. If it could be shown that securities prices reflect publicly and nonpublicly available information, benefiting from insider trading would not be possible.

"However, the results of strong form tests generally show that corporate insiders and stock exchange specialists benefit because of informational advantages."^{lxxxvi}

iii. The Semistrong Form:

The semistrong form of the Efficient Capital Market Hypothesis holds that security prices reflect only publicly available information.^{lxxxvii} Because publicly available information is already reflected in the prices, an analysis based on public available information cannot lead to above-average returns. Traders receive above-average returns only when they trade on the basis of nonpublic information. The semistrong form implies that investors with nonpublic information are more capable of estimating the true value of a security. Therefore, they earn excess returns when trading on the basis of nonpublic information. The semistrong form of the Efficient Capital Market Hypothesis is the most widely accepted as applicable to current world markets.^{lxxxviii} In *Basic v. Levinson* the Supreme Court showed, though not explicitly, its belief in the semistrong form of the Efficient Capital Market Theory.^{lxxxix}

In an efficient capital market, public announcement or disclosure of material information will always influence the stock price immediately. According to the semistrong form of the Efficient Capital Market Hypothesis, stock prices do not incorporate "information that is not publicly available, e.g., inside information about the issuer, or the unexpected possibility that a specific takeover may be made in the future."^{xc} As a consequence, insiders may profit from investing based on their information.^{xc}

- The deregulator's view on informational allocation

Deregulators argue that prohibiting insider transactions has a negative effect on the creation and the spread of information in the capital market.^{xcii} *Fischel* describes insider trading as a "mechanism of communicating information."^{xciii} Permitting insider trading would create incentives for insiders to produce positive information in order to be the first to benefit from it. Deregulators argue that insider transactions move stock prices in the right direction, that is, market efficiency increases, because insider trading adjusts stock prices in the right direction.^{xciv}

If this were true, the investor would pay a more accurate and lower price for the security than they would without insider trading, and the free market will produce results which conform with broader social objectives. Deregulators argue that insider trading benefits society. Insider trading smoothes changes in stock prices, and thereby decreases volatility.^{xcv} Therefore, it leads to an increased attractiveness of the securities market, especially for risk-averse investors.

The underlying notion is that insider trading provides the market with information. Those who trade with insiders sell at higher prices in the case of good news or purchase at lower prices in the case of bad news. Since not all information is reflected in a form communicable to the market, insider trading supposedly fulfils a communicative function. An increase in trading volume caused by insider trading could signal to the market that there is undisclosed information which is not being reflected in the price. Deregulators, therefore, think that insiders' gains are the price society pays for the beneficial effect of market efficiency.^{xcvi}

- The regulator's position

The direct effect of insider trading on the spread of information seems plausible at first. However, regulators argue that insiders hide their orders, thereby disguising new information. Insiders must place hidden orders to be able to benefit from the information they possess.^{xcvii} Regulators argue that insider trading generates no price signaling effect.^{xcviii} They also question the assumption that unregulated insider trading enhances market efficiency relying on early market studies which show that insider trading did not affect the price significantly in most cases.^{xcix}

According to later studies, the market reacts quickly when insiders buy securities, but price changes are minimal when insiders sell their securities.⁵ Other, more recent studies

reveal that transactions by insiders had a strong price effect. However, no transactions were based on nonpublic information.^{ci}

Empirical studies support regulators in their statement that stock prices are not significantly affected, unless investors believe that new information about the issuer is available. According to these studies, the market efficiency argument of the deregulators appears in another light.^{cii} Insider trading does not communicate information as deregulators claim.

Deregulators also claim that insiders sell if they possess adverse inside information. Increased sales volume in the market results in falling prices.^{ciii} However, the supply effect of insider trading does not affect the price significantly, because it "is simply too small."^{civ}

Gilson and Kraakman's statements raise doubts whether insider trading leads to informational efficiency.^{cv} This conclusion is rooted in the "derivatively informed trading mechanism."^{cvi} This mechanism describes the fact that market prices are influenced in a "two-stage"^{cvi} process. First, insiders begin trading on the basis of nonpublic information, affecting the market price only minimally. Second, outsiders gain knowledge either through tipping, leakage, or market observing. Finally, the market reacts. The crucial issue, however, is that derivatively informed trading is slow and sporadic.^{cviii} Therefore, insider trading does not affect the efficiency of securities markets.^{cix}

There is also evidence that prices are only affected when insider trading is signaled to the market.^{cx} However, it is not clear whether or not insider trading signals the right information to the market. Investors can only observe that new information is available, but not what that information specifically entails.

Additionally, according to regulators unregulated insider trading may not communicate all information to the securities market. Bad information may not be revealed, or only be revealed slowly, whereas insiders are anxious to profit from good news through disclosure.^{cx} Regulators doubt that insider trading conveys information to the market. They argue that insider trading cannot substitute disclosure because too much "noise" is associated with trading.^{cxii} Investors may use non-accurate financial information and trade for personal or political reasons and not because of nonpublic material information about the value of the issuer's assets or a particular kind of risk. This sends mixed price signals or "noise".^{cxiii}

Consequently, even if one assumes that insider trading communicates new information to the securities market, many questions remain unsolved.

(b) Allocational Efficiency

Allocational efficiency refers to the use of capital resources in the most productive manner.^{cxiv} Information about firms with promising or probable future earnings should cause prices of their securities to rise; the market price of securities of firms with less

promising earnings prospects should decline. Society allocates resources to investments promising greater returns and away from those with less promise. Thus, efficient stock prices assure that capital is used in the most efficient way.

Older literature points out the problem that material information is often withheld.^{[cxv](#)} Mendelson drew the conclusion that withholding information impairs the allocational efficiency because there is inaccurate pricing.^{[cxvi](#)} Insiders might also delay disclosure of material information to benefit from trading before disclosure.^{[cxvii](#)} However, delays in disclosure, today, due to insider trading are "infrequent and short-lived and will thus have only little or no effect on the allocation of resources."^{[cxviii](#)}

Despite this observation, risks still remain, that corporate insiders have an interest in manipulating the market through the timing of press releases in another way. They may delay a release if it will increase the market volatility.^{[cxix](#)} Delay of disclosure, however, adversely affects the market's allocational efficiency because it reduces accurate pricing. Regulators believe that trading cannot avoid the mispricing effect.^{[cxx](#)} Only disclosure assures accurate pricing.

(c) Operational efficiency

Insider trading also, arguably, increases transaction costs by increasing the bid-ask spread.^{[cxxi](#)} Reaction of market-makers to insider trading purportedly causes this increase. A market-maker benefits from buying at his bid and selling at his ask. According to Schmidt, market-makers are "prime targets of insider trading and always lose to insiders."^{[cxxii](#)} Insiders deal with market-makers only if they anticipate that they will realize higher profits than the brokerage fee.^{[cxxiii](#)} Market-makers do not know whether they are dealing with insiders.^{[cxxiv](#)} When they think that they are trading with insiders, they may increase the bid-ask spread. The increase in the bid-ask-spread will ultimately increase the cost of capital, as marginal, uninformed traders leave the market. Those who stay will change the proportion of investment in debt and equity.^{[cxxv](#)} Higher costs of capital curtail investment and thereby weaken the growth of the economy. Therefore, general welfare may decrease.^{[cxxvi](#)}

2. Increase of the cost of Capital

Not only market-makers, but also sophisticated investors, protect themselves against insiders. Because insider trading occurs randomly, investors do not know about which firm material information is available, and whether insiders are trading on the basis of nonpublic information. Therefore, investors must "assume that every investment presents the same risk of insider trading as does the market as a whole."^{[cxxvii](#)} Accordingly, some investors leave the market while others discount the value of any individual firm by the average agency cost of all firms.^{[cxxviii](#)} Discounting protects against the fact that the investor cannot distinguish between firms whose shares are and are not affected by insider trading.

While investors can protect themselves, and are, thereby, not directly harmed, insider trading may harm the issuers of securities.^{cxxxix} Their cost of capital increases by the amount that the investors discount the price of their securities.

Akerlof illustrates another detrimental effect by scrutinizing the market for used cars.^{cxxx} Used cars can either be lemons or satisfactory. An individual is more inclined to sell a lemon than a satisfactory vehicle. Realizing this, buyers value all cars at less than their actual value. Therefore, the seller obtains neither the value of a good car, nor the average value of a good and a bad car.^{cxxxix} This study shows how informational asymmetry detrimentally affects the market. This article concludes that markets break down because market participants do not value the good quality highly enough. The same effect can happen to the securities market when information asymmetry leads to withdrawal from the market. The breakdown of the market would lead to an increase of capital costs as well as a decrease the liquidity in of the stock market.^{cxxxii}

Deregulators might respond that insider trading reduces this informational asymmetry. However, insider trading eliminates the informational asymmetry *ex post* but the market suffers damaging effects if investors perceive the asymmetry *ex ante*.^{cxxxiii} Therefore, disclosure becomes the only measure which can attack the informational asymmetry.

Evaluation of the capital market arguments

The observation in the preceding subchapter focused on capital market processes. On the one hand, I agree with the statements of regulators describing the possibility that insiders may mask their trading activities. In my opinion, insiders, understandably, want to complete their transactions before the information becomes public. On the other hand, I believe that one should be aware that masking is almost impossible because specialists on the stock exchanges attentively observe the market development. However, this view is only valid within certain limits. The attentive observation of the New York Stock Exchange does not necessarily help if information in California is available. However, I agree with the statements of regulators based on the "derivatively informed trading mechanism" and "noise," which question that insider trading tends to informational efficiency.

Furthermore, the consequence concerning allocational efficiency is not predictable with certainty, due to the fact insiders cannot completely hide their transactions. Therefore, in my opinion, detrimental effects on allocational efficiency are not a particularly strong support for an insider trading regulation.

The argument, based on the assumption that insider trading leads to an increase of the bid-ask spread, also seems unconvincing, since computerization of stock exchanges has generally led to a decrease in the bid-ask spread.

However, it is detrimental to the securities market if sophisticated outsiders react to insider trading and are "unwilling to pay for the full expected value of forthcoming investment returns."^{cxxxiv} Decreased liquidity of the market and increase of the costs of

capital may have far-reaching consequences. In this context, regulators can rely on Akerlof's observation of a market breakdown under certain conditions.

Therefore, with regard to market efficiency, insider trading has no desirable advantages over mandatory disclosure. Price changes occur more quickly through public disclosure. Outside investors are better off without insider trading. With insider trading on bad news an outside investor might buy a stock which has a lower value than its purchase price. In the case of insider trading on good news, an outside investor may sell a stock at a price which is below its price following disclosure.^{cxxxv} It is worthwhile pointing out that the current laws do not oppose informational efficiency. Modern insider trading regulations not only prohibit the use of nonpublic material information, but they also enforce the disclosure of nonpublic information by the issuer.^{cxxxvi}

III. Fairness Arguments

Average people often argue that insider trading is unfair.^{cxxxvii} However, also "members of the financial community, regulators, lawyers, and judges seem to be based on the idea that such trading, by giving insiders an unfair advantage, will discourage ordinary investors."^{cxxxviii} This view is either based on intuition or on the effects of insider trading on the distribution of justice.^{cxxxix} Intuition is not necessarily a good basis for condemning insider trading since there are, as shown already, strong arguments in favor of unregulated insider trading which are at least worth considering. Schäfer and Ott state that the argument of distributional justice "assumes naive outsiders." Sophisticated outsiders take into consideration that their expected returns per share is lower than the average return per share, because insiders hold parts of the stock in good periods, whereas outsiders hold all of the stock in bad periods. Sophisticated outsiders will discount this loss and pay a lower price or demand a higher dividend."^{cxli} Therefore, outsiders are not harmed according to Schäfer and Ott.^{cxli} The effect of the investor protection -- the increase of cost of capital -- was already discussed. The Securities and Exchange Commission (SEC) is opposed to unfairness on the capital market. *In re Cady, Roberts & Co*, the SEC proclaimed that one purpose of the securities laws is to eliminate the "use of inside information for personal advantages."^{cxlii} The Supreme Court also acknowledged that the Securities and Exchange Act of 1934 was drafted "to restore public confidence in financial markets."^{cxliii} It made this position even more clear in *O'Hagan* applying the misappropriation theory. It found that the theory is "well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."^{cxliv} Interestingly, not with a single word the Supreme Court addresses the necessity of regulating insider trading, but rather applies a rigid theory which can promote the investor confidence in the integrity of securities markets. Thus, the Supreme Court realized the importance of investor confidence and the connection between it and the proper functioning of capital markets.^{cxlv}

The intuition of investors and their feeling for justice and fairness should not be underestimated. If investors feel unfairly treated they may lose confidence in the integrity of the securities market. These investors would then withdraw from the market and invest in other opportunities.^{cxlvi} This view clarifies why concern about the confidence of

investor in the integrity of the market was a motive for the enactment of the insider trading prohibition.^{cxlvii} Informational disadvantages, however, are not uncommon in our world and they are not illegal *per se*. The question is, what constitutes a problem with regard to trading on nonpublic material information about an issuer of securities. The problem lies not in the possession of information, but in access to that information. This inequality is unfair because an outside investor cannot independently and lawfully acquire the same information that the corporate insider can. Thus, outsiders can never overcome the insiders' advantages resulting from the access to material information.^{cxlviii} Put another way, fairness is achieved when insiders and outsiders are in equal positions.^{cxlix}

Deregulators point out that the presence of insiders has not led to a significant decrease of the number of investors participating in the securities market.^{cl} This argument does not carry much weight because the fact that investors have not (yet) changed their preferences for investment is not a reason for the law to abandon them by giving up all attempts to provide equitable securities markets. Cox and Fogarty state that "markets appear to function successfully in nations where official attitudes toward insider trading traditionally have been more benign than in the United States."^{cli} It is interesting that Germany, as a country with an "official[ly] benign attitude towards insider traders" gave up its opposition against the Insider Dealing Directive of the European Union, which it finally implemented as national law. After more than twenty years of discussions, Germany had to recognize that insider trading regulations are seen as a "guaranty seal",^{clii} essential for global competition.^{cliii} The international development of securities law shows that countries increasingly recognize that the regulation of insider trading is a factor which global institutional investors require as a condition of investment. Cox and Fogarty's argument is no longer valid. A closer look at the preamble of the EC-Insider Dealing Directive of 1989 shows that investor confidence was a main base for the regulation of insider trading:

Whereas for that market to be able to play its role effectively, every measure should be taken to ensure that market operates smoothly; whereas the smooth operation of that market depends to a large extent on the confidence it inspires in investors; whereas the factors on which such confidence depends include 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; whereas, by benefiting certain investors as compared with others, insider dealing is likely to undermine that confidence that confidence and may therefore prejudice the smooth operation of the market.^{cliv}

In this respect the motivation for the EC-Insider Dealing Directive is not different from the introduction of the Insider Trading and Securities Fraud Enforcement Act of 1988,^{clv} that is, that it stems from fear that the capital market might suffer detrimental effects.

Investors' confidence is fundamental for the proper functioning of securities markets. A well functioning securities market is a precondition of the common wealth. Therefore, legislatures must maintain and restore this confidence. As long as outside investors

experience unequal treatment, potential risks for the capital market will remain, even if economic advantages could be derived from insider trading.^{clvi}

Evaluation of fairness arguments

Although deregulators question fairness considerations and arguments, these arguments are closely connected to investors' confidence of in the integrity of the securities market. I think the legislators enacting insider trading regulations were correct when they considered investors' confidence a serious matter for the proper functioning of the market. The growth of mutual funds may be a sign that investors do not trust direct investment in securities. Therefore, the withdrawal of investors from the market is not only a hypothesis.

IV. Harm to the Individual Investor

Major controversy exists about whether insider trading harms the individual investor.^{clvii} "An individual shareholder is said to be harmed because either he would have gotten a better price if the inside information had been disclosed before trading by the insider, or he would not have traded at all."^{clviii} However, the problem is that the shareholder would act anyway, regardless whether insiders trade on the basis of nonpublic information.^{clix} Therefore, deregulators question the notion that anyone is seriously harmed by insider trading.^{clx} Manne advanced the argument that noninsiders are not likely to be harmed by insider trading,^{clxi} a theory called the "victimless hypothesis."^{clxii} Insiders do not directly influence the trading of those who trade in the opposite direction on the basis of an independent decision nor of those who trade in the same direction.^{clxiii} Insiders cause trading only if they induce the other party of the transaction to trade in the opposite direction or insiders preempt trades of the same type.^{clxiv}

However, since insider trading arises on impersonal stock markets, it may be difficult to find a causation between insider activities and investors' harm. A response to this argument is that investors are induced or misled to buy or sell because of the price movements caused by insider trading.^{clxv} This assumption is, however, problematic since the effect of insider trading on price movements is uncertain. In my opinion, one must pursue a consistent view: One cannot question on the one hand the price-moving effects of insider trading, but use the same argument to create a causal relationship between insider trading and economic harm of investor. As a consequence, I believe that this assumption does not answer the causal problem whether insiders induce outsiders to trade in the "opposite direction."^{clxvi}

Supporters of the "victimless crime" theory rely on the fact that the outsider acted voluntarily and would have sold or purchased in any event.^{clxvii} Klock, a legal and economic scholar reveals several shortcomings in Manne's victimless crime assumption.^{clxviii} The first flaw he finds in Manne's own reasoning is that noninsiders are harmed in the case of insider trading on bad information.^{clxix} Klock also points out that Manne relies only on "a single transaction in isolation and holds everything else constant in a nirvana-like fallacy,"^{clxx} a so-called partial equilibrium model.^{clxxi} The difference

speaking of securities markets is that prices "impact upon prices of physical capital."^{clxxii} Therefore, a general equilibrium analysis is required.^{clxxiii} Manne is also considered incorrect when rejecting the argument that insider trading leads outside sellers to sell for less than if they were in possession of the information.^{clxxiv} Manne compares prices with and without inside information before the information is disclosed. He does not consider that in a world of unregulated insider trading, investors anticipate losses to insiders and adjust their behavior. Klock contends that Manne who "attack[s] his critics for looking at the outsider's position ex post rather than ex ante ... is looking at the situation ex post with respect to the outsider's investment decision."^{clxxv}

A different hypothesis focuses on the investors as a group, rather than on the individual investor.^{clxxvi} Wang identifies economic harm of insider trading according to the "Law of Conservation of Securities."^{clxxvii} He states that "with a purchase of an existing issue of securities, someone ultimately has less of that issue; with a sale of an existing issue, someone ultimately acquires more of that issue."^{clxxviii} Therefore, insiders win at the expense of outsiders.^{clxxix} If the inside trader had not traded, someone else would have. Thus, insider trading preempts others from buying in the case of good news or from selling in the case of bad news.^{clxxx} According to Wang, someone loses in the end if an insider enters the market.^{clxxxi} However, Wang also identifies the shortcomings of this approach: When insider trading takes place on the stock market an identification of victims is impossible.^{clxxxii} Additionally and as already stated, outsiders can act independently, that is, without inducement of insiders.

Evaluation of the arguments with regard to harm

In my opinion, the hypothesis that the individual investor suffers economic harm is not a particularly strong basis for regulation. It is hardly possible to create a causal relationship between insider trading and harm arising on impersonal stock markets. Therefore, the argument that insider trading harms the individual investor is based on too many speculative assumptions.^{clxxxiii} This does not mean, however, that insider trading regulations do not focus on individual investors. Insider trading regulations aim to win investors' confidence by providing fair trading and market integrity more than protecting the individual investor. Protecting against direct economic harm cannot be the primary aim because direct harm is speculative and hard to prove. Clearly, this does not mean that all protection of the individual investor is denied.^{clxxxiv} The role of investors' harm as a justification for regulating insider trading can be seen when looking at the compensation of investors who claim injury from insider trading. The new German Securities Trading Trade Act does not permit the assertion of such a claim against insiders. Furthermore, the German Securities Trading Act is not a law protecting individuals (*Schutzgesetz*) in the meaning of section 823, paragraph 2 of the German Civil Code, because the Securities Trading Act does not protect individual investors, but rather investors as a group of potential investors.^{clxxxv} Therefore, neither claim is possible. Under the current U.S. law, only persons who traded "contemporaneously" or who had a contract with an insider may claim compensation.^{clxxxvi}

Final Conclusion with Regard to Demand for Regulation

There are no clear and easy answers to the question of regulating insider trading. Insider trading may have benefits for both the company and the capital market under certain conditions. However, the arguments against regulation show a certain vagueness and cannot refute the well-founded doubts of regulators. Even though scholars often argue that fairness considerations do not carry much weight, the personal feelings of the individual investor and his confidence in the integrity of securities markets must be taken into account. Although insider trading can have positive effects for the firm and its wealth, as the arguments of deregulators show, it also bears several severe risks. The costs seem to outweigh the benefits.^{clxxxvii} Therefore, it is correct to prohibit insider trading by a mandatory regulation.

Part 2: The Basic Elements of the U.S. Insider Trading Regulation

I. Background

Before Congress enacted the Securities Exchange Act (SEA) in 1934 in the wake of the stock market crash of 1929, common law dealt with insider trading. Common law applied the standards of material misrepresentation,^{clxxxviii} that is, an insider was only liable when a fiduciary duty or other relationship of trust and confidence existed between the parties.^{clxxxix}

Today, the main tool fighting insider trading in the United States is section 10(b) of the SEA^{cxc} and rule 10b-5 which the Securities and Exchange Commission (SEC) promulgated under section 10(b) in 1942.^{cxc}

Section 10(b) provides:

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

(b) 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

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 of 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 statements 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.

Due to the broad language of section 10(b) and Rule 10b-5, courts and the SEC play a significant role in the practical application of these provisions.^{cxci} Both provisions serve as "catchall" clauses against insider trading.^{cxcii} The term "insider trading" is not defined. Therefore, an understanding of the U.S. approach regarding insider trading requires a brief look at the landmark cases when discussing the following subchapters.

II. Who is liable as an insider?

1. Traditional and temporary insiders

The cases *Cady, Roberts & Co.*,^{cxciiv} *Chiarella*^{cxci} and *Dirks*^{cxci} reveal that traditional insiders,^{cxci} such as directors and officers, and temporary insiders may be held liable under section 10(b) and rule 10b-5.

Cady, Roberts & Co.

An important step in developing the parameters of Section 10(b) SEA can be found *In re Cady, Roberts & Co.*,^{cxci} the first SEC decision to address insider trading on the open market. The Commission recognized that corporate insiders must disclose all material information known to them or refrain from trading. The Commission extended the reach of Rule 10b-5 to "any person" having an affirmative duty to disclose material insider information. According to the Commission this duty derives from the "relationship giving access, directly or indirectly, to information intended to be available only for corporate purpose and not for the personal benefit of anyone, and ... [from] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."^{cxci}

SEC v. Texas Gulf Sulphur Co.

Although the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*^{cc} cited *Cady, Roberts & Co.* with approval, it removed the requirement that there had to be a "relationship" giving access to information and that "inherent unfairness" must be shown in the transaction. The court held that Rule 10b-5 prevents insiders as well as those possessing inside information, who may not be strictly termed an insider, from trading unfairly.^{cci} The doctrinal advantage of the approach in *Texas Gulf Sulphur* is that it supports a simple rule against exploiting almost all informational disparities that are popularly perceived to give an unfair trading advantage. Consequentially, Rule 10b-5 reaches tippees, financial printers, and officers of an issuing corporation if they violate their obligation to disclose

or abstain. They are also liable if the information stems from outside the corporation, since the essence of the wrongdoing lies in exploiting an informational advantage over other traders.^{ccii}

Chiarella v. United States

However, the Supreme Court rejected the equal access theory of *Cady, Robert, & Co.* and *Texas Gulf Sulphur* in its first insider trading case, *Chiarella v. United States*.^{cciii} It overturned the criminal conviction of Mr Chiarella, a financial printer, for trading on knowledge of pending takeover bids. Although the court recognized the duty set forth in *Cady, Roberts & Co.*, it refrained -- unlike the SEC in *Cady, Roberts & Co.* -- from extending the duty to those other than corporate insiders.^{cciv} The majority opinion *Chiarella* court introduced the fiduciary duty as a narrower basis for regulating insider trading. Under this theory Rule 10b-5 bars trading on nonpublic information when an insider owes a duty to disclose based on "a relationship between the parties to a transaction."^{ccv} This theory has the effect of conforming the law of insider trading to the requirements of common law fraud which required a duty to disclose only in a fiduciary relationship.^{ccvi}

Dirks v. United States

The Supreme Court reiterated its findings of *Chiarella* in *Dirks*.^{ccvii} It also extended liability to "temporary" insider.^{ccviii} Therefore, the liability of section 10(b) and rule 10b-5 also reaches persons who stand outside the corporation, "but rather [...] have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."^{ccix} This liability applies to advisors, lawyers and any other persons who are outsiders, but who also become fiduciaries of the shareholders.^{ccx}

Chiarella and *Dirks* hold traditional insiders, such as officers and directors, and temporary insiders liable under the federal securities law. "Although Chiarella's conviction and Dirks' censure both were reversed, the Court stated that rule 10b-5 prohibits insider trading on an impersonal stock market if a special relationship exists between the buyer and the seller."^{ccxi} Liability was extended to "temporary" insiders.

2. *Tippers*

A corporate insider who, for his own benefit, conveys material inside information regarding the corporation to a third party is deemed a tipper. The most important case addressing to tipper's liability is *Dirks*.^{ccxii} The Supreme Court held that "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."^{ccxiii} Consequentially, tipping is a primary violation of rule 10b-5 and is not different from the primary violation occurring when the insider trades. However, the tipper must have breached a fiduciary duty to shareholders.^{ccxiv} According to Justice Powell the test for determining whether the tipper breached a fiduciary duty depends upon "whether the insider personally will benefit, directly or indirectly, from his

disclosure. Absent some personal gain, there has been no breach of duty stockholders."^{ccxv}

3. Tippees

The *Dirks* court established the conditions under which tippees can be held liable. The court stated that a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material, nonpublic information only under two conditions.^{ccxvi} First, the insider must have breached his fiduciary duty to the shareholders by disclosing the information to the tippee and second, the tippee knows or should know that there has been a breach. Thus, the Supreme Court imposed a derivative fiduciary duty on tippees.

4. Employees of the issuer

If independent contractors can become fiduciaries of the issuing corporation^{ccxvii} it follows from *a fortiori* argument that independent contractors, such as employees are in the required fiduciary relationship to the issuer.^{ccxviii} Wang and Steinberg state that the employee "need not be a high-level employee."^{ccxix} Furthermore, former officers and employees remain under a fiduciary duty.^{ccxx}

5. Issuing corporation itself

If employees are held liable under the federal securities law it follows that a fiduciary duty also exists between the issuing corporation itself and its shareholders.^{ccxxi} Furthermore, they state that the issuer is not allowed to tip for its own benefit.^{ccxxii} When an insider acts not directly, but rather through the corporation the corporation will be held directly liable.^{ccxxiii}

6. Shareholders of the corporation

A person owning a single share of the corporation does not owe a fiduciary duty to the other shareholders.^{ccxxiv} There is only rare case law regarding this questions.^{ccxxv} Loss and Seligman,^{ccxxvi} however, state that controlling shareholders owe a fiduciary duty to other shareholders because "directors are, in effect, representatives of the controlling person and it poses little analytical challenge to relate back to the controlling the director's disclose or abstain duty."^{ccxxvii} Therefore, controlling are liable as insiders.

III. The significance of the misappropriation theory

There is no debate whether corporate insiders may not trade on the basis of nonpublic information without prior disclosure. Regarding outsiders, the described liability in the previous chapter only showed the opinion of the majority in *Chiarella*. There is a debate whether individuals which have access to material nonpublic information, but do not stand in a relationship of trust and confidence to the shareholders of the corporation must also disclose or abstain.

The majority in *Chiarella* decided that a duty to disclose arises only from a fiduciary or other similar relationship of trust and confidence between the buyer and the seller.^{ccxxviii} Chief Justice Burger wrote in his dissent that rule 10b-5 should be interpreted to "mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading."^{ccxxix} His findings became the source of the misappropriation theory. Under the misappropriation theory, rule 10b-5 is violated when an individual "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."^{ccxxx}

Thus, by design the misappropriation theory reaches people outside the issuing corporation. Therefore, in *Chiarella*, Mr Chiarella, who had no relationship with the issuing corporation, was held liable. In *Carpenter*,^{ccxxxi} the Supreme Court barely affirmed the conviction of a journalist under rule 10b-5 and the misappropriation theory by a 4-to-4-vote. In this case, a journalist allowed a stockbroker to trade on advance information about the content of a column in the Wall Street Journal. However, the court unanimously affirmed the mail fraud conviction. After *Carpenter*, the Second Circuit immediately applied the misappropriation theory again^{ccxxxii} and was supported by the Ninth Circuit^{ccxxxiii} and the Seventh^{ccxxxiv} Circuit. When the Fourth Circuit rejected the misappropriation theory in *Bryan*, the whole issue became in a status of chaos.^{ccxxxv}

In *O'Hagan*, the Eighth Circuit rejected the misappropriation theory as well.^{ccxxxvi} Recently, the Supreme Court approved the validity of the misappropriation theory in *O'Hagan* giving a clear signal to the securities market. It ruled that "a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of information, may be held liable for violating Section 10(b) and Rule 10b-5."^{ccxxxvii} Thus the Supreme Court found that the statutory requirements of Section 10(b) are met, that there be a deceptive device "in connection with" a purchase or sale of securities. The decision is important for persons who have no special relationship to the corporation in which securities they trade. If a person misappropriates information nonpublic material information in breach of a fiduciary duty owed to the source of the information and uses the misappropriated information for securities transactions, he is liable. The Supreme Court emphasized that the misappropriation theory is not a new theory, but that the classical theory and the later are rather complementary. Whereas the classical theory addresses a corporate insider's breach of a duty to shareholders with whom the insider transacts, the misappropriation theory is designed to reach outsiders breaching a duty owed to the source of information and not to the trading party.

IV. Inside information

There is no definition of the term "inside information." The duty to disclose or abstain arises only if the information is (a) material and (b) nonpublic.^{ccxxxviii}

(a) Material information

In *TSC Industries, Inc. v. Northway*,^{ccxxxix} the Supreme Court established a general standard with regard to the "material" requirement in the proxy-soliciting context. According to the Supreme Court "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."^{ccxli} In *Basic v. Levinson*,^{ccxli} the Supreme Court adopted the *TSC* standard of materiality regarding insider liability of insiders pursuant to rule 10b-5. The Supreme Court refined the *TSC* standard by stating that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity."^{ccxlii} The information must affect a reasonable investor's behavior who possesses general professional knowledge. Consequentially, information material only to investors with unique expertise or because of specific research is not considered material.^{ccxliii}

(b) Nonpublic information

Today, there are two different approaches in determining when material information is considered public.^{ccxliv} According to the first view, information is public "when it has been disseminated and absorbed by the investment community. Dissemination consists of releasing the information to the press and having it reported in some widespread medium. Absorption means a reasonable waiting period to allow the investor to make an informed decision."^{ccxlv} This is the democratic view of the SEC.^{ccxlvi} In *re Investors Management Co.*,^{ccxlvii} the SEC held that material information must be disseminated in a manner calculated to reach the general market through recognized distribution sources. However, dissemination is not sufficient. The *Texas Gulf Sulphur Co.* court states that insiders may not trade before the information is absorbed by the investing public.^{ccxlviii} Therefore, insiders must wait a certain period for the public to assimilate the information.

The second view follows the Efficient Capital Market Hypothesis.^{ccxlix}

Information is considered public when it is known by the active investment community. If a sufficient number of active investors have knowledge of the information, the price of the security will reflect the information (even though the average investor may not be aware of it). Prior to such information's absorption into the efficient-market, an insider (or other person subject to the disclose-or-abstain mandate) will be prevented from profiting on the information, thus neutralizing any advantage such person possesses.^{ccli}

The second view requires only a limited amount of dissemination and a shorter waiting period before.^{ccli}

Generally, the question whether information is disseminated properly depends on "the scope of coverage (local or national), specificity, and clarity of media exposure."^{cclii} No defined duration of the waiting period exists. It rather depends on variable factors, "such as how quickly the information is translatable into the investment decision, how wide the dissemination, how active the market in the security, and how widely the security is followed by analysts."^{ccliii}

V. Scienter

Section 10(b) and rule 10b-5 require a showing of scienter as a requirement of liability.^{ccliv} Negligent conduct is certainly insufficient.^{cclv} However, it is difficult to determine which state of mind is required.^{cclvi} In many cases, reckless conduct was held sufficient.^{cclvii} The scienter requirement is easily established with regard to traditional and temporary insiders. They are presumed to possess knowledge of undisclosed information.^{cclviii} The Supreme Court applied the standard to tippees that they know, or "should know that there had been a breach by the insider."^{cclix}

VI. "In connection with the purchase or sale of any security" requirement

An action under section 10(b) requires that the manipulative or deceptive conduct was "in connection with the purchase or sale of any security." Insider cases, in which traditional insiders trade with a victim to whom they owe a fiduciary duty, easily satisfy this requirement.^{cclx} The Supreme Court states that the requirement is satisfied when someone suffers "an injury as a result of deceptive practices touching [his] sale of securities of an investor."^{cclxi} The "in connection with" requirement causes no problems in classical insider trading where the insider defrauds the other party of the securities transaction. However, in *O'Hagan* that the § 10(b)'s requirement that the conduct involve a "deceptive device or contrivance" used "in connection with" a securities transaction.^{cclxii} The Court's main argument is that the fraud is only consummated when the misappropriator uses the confidential information for a securities transaction, and not already when he obtains the information.^{cclxiii} Even though the Court notes that the person or entity defrauded is not the other party to the transaction, but rather the source of information. Nevertheless, the Supreme Court held that the "in connection with" requirement is met.

Admittedly, this is a broad reading of § 10(b). However, the misappropriation theory only addresses cases where misappropriated confidential information is capitalized through securities transactions. The Supreme Court points out limitations, i.e. the misappropriation does not apply to cases where a misappropriator uses such information for other than trading purposes.^{cclxiv}

From my point of view this notion of the Supreme Court is correct. It is the needed signal to investors that the honesty and integrity of the capital markets are protected by law. The Supreme Court realized the importance of the investor confidence for a functioning capital market.

It became clear that the U.S. insider trading law has no problems to reach traditional insiders and people who stand in a "special relationship" with the corporation. The problem under the current insider regulation arise if people outside the corporation become insiders. Therefore, it will be interesting to see how Germany deals with this specific problem.

Part 3. Insider Trading in Germany

I. The historical background of the Securities Trading Act of 1994 (*Wertpapierhandelsgesetz*)

In Germany, legislative prohibition is very recent. For a long time, Germany represented a capital marketplace which refused to take the regulation of insider trading seriously. Until 1970, no regulation existed at all. Then, non-binding "Insider Trading Guidelines" (*Insiderhandelsrichtlinien*) were adopted in 1970^{cclxv} and thereafter amended in 1976 and 1988. However, the "Insider Trading Guidelines" were only a voluntary code of behavior to which one had to subject oneself expressly.^{cclxvi} While persons, such as bankers, directors and officers of German corporations, claimed that a voluntary code was sufficient to restrict insider trading,^{cclxvii} legal scholars always asked for a mandatory regulation.^{cclxviii} Foreign investors did not trust the guidelines and acted accordingly.^{cclxix} The debate whether there should be voluntary guidelines or a mandatory regulation ended when the German legislature enacted the Securities Trading Act (*Wertpapierhandelsgesetz*)^{cclxx} on July 26, 1994.

The Securities Trading Act of 1994, enacted with passage of the "Second Financial Market Promotion Act" (*Zweites Finanzmarktförderungsgesetz*), made insider trading a crime. Germany had rejected the enactment of European insider regulation for more than twenty years, but finally relinquished its objections to the EC-Insider Trading Directive in 1989. The major incentive for change in Germany's treatment of insider trading is probably to be found in the activities of the European Community. The Council^{cclxxi} issued this Insider Trading Directive on November 13, 1989.^{cclxxii} The reason for Germany's turnaround was that the directive was no longer based on Article 100 of the Treaty of Rome requiring an unanimous vote in the Council,^{cclxxiii} but on Article 100a of the Treaty of Rome requiring an unanimous vote.^{cclxxiv} Germany also realized that it would lose its reputation as a developed capital market.^{cclxxv}

Directives of the European Community are only addressed to the member states and not binding for individuals. Member states must transform the provisions of the directives into national law. The EC- Insider Trading Directive actually required the Member States to take the measures necessary to comply with its provisions by June 1, 1992. However, Germany did not comply until July 1994 when the German parliament (*Bundestag*) approved legislation outlawing insider trading.^{cclxxvi} The Securities Trading Act regulates insider trading in sections 12 to 20, 38, 39.

II. Key elements of the German insider regulation

1. Insider securities

The provisions regulating insider trading apply to "insider securities" (*Insiderpapiere*).^{cclxxvii} Section 12^{cclxxviii} defines the term "insider securities" as securities which are admitted to trading on a domestic stock exchange or included in over-the-counter trading (section 12, paragraph 1, number 1). However, it is also sufficient if the security is traded on a stock exchange within another member state of the European Community or in another contracting state to the European Economic Area Agreement

(section 12, paragraph 1, number, 2). The term security itself is defined in section 2 of the Securities Trading Act as:^{[cclxxxix](#)}

1. stocks, certificates representing stocks, bonds, profit-sharing certificates, option certificates,
2. other securities comparable to stocks or bonds, when they can be traded in a market regulated and supervised by governmentally approved offices. The market must regularly operate and must be directly or indirectly accessible to the public. Section 12, paragraph 2 extends the term "insider security" to derivatives.^{[cclxxx](#)}

2. Insider Facts (*Insidertatsache*)

The Securities Trading Act defines "insider facts" in section 13, paragraph 1 of the Securities Trading Act: Insider facts are facts not publicly known relating to one or several issuers of "insider securities" which are capable of substantially influencing the price of the "insider securities" in the event of their disclosure.^{[cclxxxix](#)} The expression "facts" (*Tatsache*) implies that insider facts can only be objective facts, *i.e.*, pure opinions and rumors are not facts.^{[cclxxxii](#)} The provision requires that the facts are not publicly known. Facts are publicly known when an indefinite number of persons has acquired knowledge of it.^{[cclxxxiii](#)} However, this does not mean that every investor must know the facts. It is sufficient if a "certain part of the public has received knowledge."^{[cclxxxiv](#)} Therefore, facts are considered public if the investing community, such as institutional investors, market makers, specialists, and other participants of the market, knows them.^{[cclxxxv](#)} Facts need not to be published through mass media, but only through "generally accessible information systems."^{[cclxxxvi](#)}

Furthermore, there must be a connection between the facts and issuer. Examples for the "connection requirement" are reduction of equity, changes in the charter and by-laws, important innovations and important contracts.^{[cclxxxvii](#)}

Additionally, section 13 of the Securities Trading Act requires that the insider facts are capable of substantially influencing the price of the insider securities.^{[cclxxxviii](#)} An objective *ex-post* perspective is applied, when evaluating this "capability."^{[cclxxxix](#)} It is insignificant whether the stock price really changes. Therefore, the insider is also liable if the stock price moves in the opposite direction, thus leading to losses.^{[cxc](#)} Concerning the requirement of "substantial influence on the stock price" (*Erheblichkeit der Kursbeeinflussung*), the German legislature proposed an orientation on the announcement of changes in stock prices.^{[cxcxi](#)} In a recent press release, the Federal Supervisory Office for Securities Trading (*Bundesaufsichtsamt für den Wertpapierhandel*) stated that it does not apply a certain percentage regarding the change in stock prices because each security has its own volatility.^{[cxcii](#)}

3. Primary and secondary insiders

The German concept, like the European insider trading concept, addresses two different groups of insiders. These groups are often defined as "primary" and "secondary insiders", however these expressions appear neither in the EC-Insider Trading Directive nor in the Securities Trading Act. It is necessary to distinguish between these two groups because they are subject to different insider prohibitions.^{ccxciii} Generally, primary insiders are persons with a direct contact to insider facts, whereas secondary insiders are defined solely by the fact that they possess inside information.^{ccxciv} The term primary insider is used because these insiders produce or receive insider facts directly and "in the proper performance of their profession" (*bestimmungsgemäß*) from the source of information.^{ccxcv} In the next chapter, this thesis first will define the term "primary insider" and describe the applicable prohibitions, and then describe the term "secondary insider" and the applicable prohibition.

a) Primary Insiders

Who is a primary insider?

The group of primary insiders is defined in Section 13 of the Securities Trading Act which relies on the EC-Insider Trading Directive.^{ccxcvi} According to section 13 of the Securities Trading Act, there are three different groups of primary insiders.

(1) A member of the management or the supervisory body^{ccxcvii} or a personally liable shareholder of the issuer or an enterprise affiliated with the issuer who has knowledge of "insider facts" (*Insidertatsache*) through his respective position.^{ccxcviii} (Section 13, paragraph 1 number 1).

In the most common case, members of the "managing board" (*Vorstand*) or the "supervisory board" (*Aufsichtsrat*) of a "stock corporation" (*Aktiengesellschaft*) are primary insiders.^{ccxcix} However, liability is not limited to members of the bodies of "stock corporations," but rather can reach members of management and supervisory bodies of "limited liabilities corporations" (*Gesellschaft mit beschränkter Haftung (GmbH)*). Additionally, because non-stock companies can also issue "insider securities" (*Insiderpapiere*) and because an affiliated enterprise can also be a limited liability company or a limited partnership, managing directors of a limited liability company or a personally liable partner of either a limited or general partnership may also be a primary insider.^{ccc} Section 13, paragraph 1, number 1 of the Securities Trading Act requires that a person receives insider facts as a member of the "management or supervisory body" (*als*). If any connection between the respective position of the insider within the corporation and the acquisition of insider facts exists this requirement is satisfied. It is not sufficient if insider facts originate from a private source.^{ccci}

(2) A person who has knowledge of "insider facts" (*Insidertatsache*) due to his participation in the equity of the issuer or of an enterprise affiliated with the issuer (Section 13, paragraph 1, number 2).^{cccii}

There is no minimum requirement with regard to the participation in the equity of the issuer.^{ccciii} The consequence of this provision is that a shareholder who owns only one share may be an insider. However, one important requirement exists, which hardly will be satisfied by shareholders who own a single share.^{ccciv} Shareholders must learn the insider facts because of (*aufgrund*) their equity in the capital. Thus, the causal requirement of the provision assures that not every equity holder is deemed an insider. Therefore, this causal requirement indirectly introduces a minimum amount of stock ownership.^{cccv}

Generally, one can conclude that there must be a relationship between the insiders and the corporation. Both insiders pursuant to Section 13, paragraph 1, number 1 and section 13 paragraph 1, number 2 of the Securities Trade Act are deemed insiders if they receive knowledge of insider facts by virtue of their particular status within the corporation.

(3) A person who has knowledge of insider facts (*Insidertatsache*) which he received in the "proper performance of his profession, activity or task."^{cccvi}

This category of insiders is often referred to as "occupational insiders."^{cccvii} It is a heterogeneous group of insiders comprising a large number of persons, *e.g.*, secretaries, employees of the issuer, accountants, tax and other advisors, lawyers, notaries, trade agents, brokers and printers.^{cccviii} There must be a causal relationship between the profession, activity or task and the acquisition of insider facts (*aufgrund*).^{cccix}

Whereas there must be a relationship between the primary insiders and the corporation according to section 13 paragraph 1, numbers 1 and 2, such a relationship is not required for "occupational insiders."^{cccx} The term insider, thus becomes very broad. The broad language, however, is narrowed by the requirement that the insider acquired information in the proper performance with his activities (*bestimmungsgemäß*).^{cccxi} It is insufficient if a person receives insider facts accidentally.^{cccxii} People who accidentally overhear insider information or otherwise happen to come across such information are not primary insiders. While lawyers, accountants and other professional advisors who obtain insider information during the exercise of their professional duties are primary insiders, psychiatrists, doctors, taxi drivers or flight attendants are not primary insiders because they receive the insider facts accidentally and not in "proper performance of their task."

Claussen explains the area of application by a very illustrative example.^{cccxiii} A widow sits next to a CEO in a plane. The CEO reads a memorandum regarding a proposal to increase the dividends of his corporation. The widow reads the CEO's papers and later uses this information to decide to buy stock in the CEO's corporation. Since the widow did not receive the information because of her occupation, employment or task, and since sitting in the plane and gathering information is not the widow's "proper performance" she is not a primary insider.

Since no contractual or any other relationship between the issuer and the insider is required, financial analysts or journalists who receive insider facts in the "proper performance of their profession" are also primary insiders.^{cccxiv}

Liability of primary insiders

Section 14, paragraph 1 of the Securities Trading Act imposes a triple prohibition on primary insiders by regulating:

An insider is prohibited from:

1. acquiring or selling insider securities for his own account or for the account of others or for the account of a third party by taking advantage of his knowledge of insider facts,
2. communicating or making available "insider facts" to another without proper authorization
3. recommending to a third party, on the basis of his knowledge of any insider facts, to acquire or sell insider securities

The prohibition in section 14 paragraph 1 applies only to insiders. When the Securities Trading Act uses the expression "insider," it actually means "primary insider" according to section 13, paragraph 1, numbers 1 to 3.

(1) Prohibition of acquiring or selling insider securities

Section 14, paragraph 1, number 1 contains the classic insider trading prohibition. It defines that an insider is prohibited from acquiring or selling insider securities for his own account or for the account of a third party by taking advantage of his knowledge of insider facts. The terms "acquiring" and "selling" of the statute require that there is a transaction in "insider securities." The transaction has to be completed, *i.e.*, the pure obligation to acquire or to sell "insider securities" is insufficient.^{[cccxv](#)}

The prohibition does not only require an objective behavior of the insider, but also a certain state of mind. An insider only violates the prohibition if he acts intentionally.^{[cccxvi](#)} As an additional subjective requirement, the prohibition requires that the insider wants to take advantage of insider facts. An insider takes advantage of his knowledge of insider facts by attempting to receive an economic advantage through this knowledge. This prohibition is designed to protect the equality between investors.^{[cccxvii](#)} The "taking-advantage" requirement is not satisfied in face-to-face-transactions.^{[cccxviii](#)} Since the German system requires intent and an additional subjective feature, it does not impose strict liability. Therefore, Freis, an author of a recent article about the new German law, has completely misunderstood the German insider trading law when qualifying it as strict liability.^{[cccxi](#)}

(2) The prohibition of communicating or making available insider facts to another without proper authorization (section 14 paragraph 1, number 2)

Section 14, paragraph 1, number 2 addresses a behavior which would be considered "tipping" applying U.S. law. The provision states that "an insider is prohibited from communicating or making available 'insider facts' to another without proper

authorization." The purpose of this provision is to limit the number of potential insiders.^{cccxx} The more people have knowledge of insider facts, the greater the risk is of insider trading tipping. However, communicating information must be allowed in certain situations. Communication within the corporation itself must be possible. In my opinion, this situation does not require special treatment. Communication of information is only prohibited if this is done "without proper authorization" (*unbefugt*). Therefore, communication within the corporation required by law is not "without proper authorization" and therefore, not prohibited. For example, pursuant to the Stock Corporation Act, management is obliged to keep the supervisory board informed. Thus, communicating insider facts to the "supervisory board" is not prohibited. Quite a similar situation arises if insiders communicate information to external parties who qualify as primary insiders pursuant Section 13 paragraph 1, number 3 of the Securities Trade Act, like lawyers, accountants and advisors. I see no specific problems since these persons are prohibited from trading as well as from communicating the information and making recommendations. Apart from this, the external parties need this information in order to fulfil their duties. I am convinced that the German legislature had a very good reason to expand the group of external insiders who receive insider facts by virtue of their profession and tasks. Since these persons can also be held liable according to the triple insider prohibition, information can be communicated to them.

However, it is quite different if a primary insider communicates information to external parties who neither stand in a contractual relationship with the issuer, nor receive the information "in the proper performance of their profession." In this context, I see no reason why the "primary insiders" as well as the recipients should be protected. Therefore, it is a clear violation of Section 14 paragraph 1, number 2 of the Securities Trading Act if a primary insider passes information to journalists or financial analysts.

(3) The prohibition of recommending (Section 14, paragraph 1, number 3)

Section 14, paragraph 1, number 3 states that "an insider is prohibited from recommending to a third party, on the basis of his knowledge of any insider facts, to acquire or sell insider securities."

Thus, this provision is designed to fill potential gaps which could arise if a primary insider does not communicate "insider fact" to another person, but only tips off the person without mentioning facts. In this case, this person does not become a secondary insider and is allowed to trade in insider securities. Thus, the main purpose of Section 14 paragraph 1, number 3 of the Securities Trading Act is to prevent collusive actions of a primary insider with a third party. Section 14, paragraph 1, number 3 can be deemed a catchall clause.

b) Secondary insiders

While the Securities Trading Act expressly defines primary insiders in Section 13 it does not define the term "secondary insiders". However, section 14, paragraph 2 of the Securities Trading Act addresses them in the context of the provision which actually

defines the insider prohibitions. This combination of the secondary insider definition and the applicable prohibition can cause problems in understanding. Therefore, the two elements are separated.

Who is a secondary insider?

Section 14, paragraph 2 addresses secondary insiders simply as "third parties" having knowledge of insider facts. Therefore, the pure knowledge of insider facts qualifies the third party as a secondary insider. Section 14, paragraph 2 does not require that the secondary insider receives insider facts through a tip from a primary insider.^{cccxxi} Consequentially, the widow in the mentioned example, is considered a secondary insider, because she possesses insider facts.

Liability of secondary insiders

Section 14, paragraph 2 regulates that secondary insiders imposes the same prohibition on secondary insiders are prohibited from taking advantage of his knowledge by acquiring or selling insider securities for his account or for the account of a third party or for a third party.^{cccxxii} Therefore, the prohibition for secondary is the same as the first part of the prohibition applicable to primary insiders. Consequentially, the same requirements have to be satisfied, as shown already in the context of primary insiders regarding securities transactions.

The widow, in the mentioned example, would be prohibited to purchase stocks if she knows that she received insider facts and if she wants to take advantage of the securities transaction.

4. Is the different treatment of primary insiders and secondary insiders under German law justified?

The German insider trading law imposes stricter limitations on primary insiders. Secondary insiders are prohibited only from trading, whereas they may communicate insider facts and give recommendations. If the German legislature had taken the purpose of the act seriously, which among others is to restrict the spread of insider information, it should have imposed the same liability to secondary insiders. It is certainly correct that the recipient of insider facts be a secondary insider who is not allowed to trade. However, a problem arises if a secondary insider simply makes a recommendation to a third party who follows the tip and buys or sells insider securities. This person cannot be deemed a secondary insider because he or she does not have knowledge of an "insider fact". However, if liability could be extended to the recommending secondary insider, the addressee of the recommendation may be criminally liable for abetting a crime.^{cccxxiii} Therefore, a gap in criminal liability may arise due to the different treatment of "primary" and "secondary insiders."

5. Sanctions for Insider Trading

According to section 38 of the Securities Trading Act, violations of the insider trading prohibitions are subject to criminal penalties, including imprisonment of up to five years or fines.^{cccxxiv} No distinction is made whether a primary or a secondary insider violated the insider trading prohibition. However, courts, when faced with that question, would apply a more lenient measure to secondary insiders.

Part 4: Application of Both Laws to a Recent Case in the United States: How would *O'Hagan* Come Out Under German Law?

A comparison of the insider trading laws of the United States and Germany reveals that traditional insiders are liable under both laws. Temporary insiders are also liable in both countries. However, the underlying concepts differ. German law does not require a "special relationship" between the issuer and the insider. The differences become very obvious where persons outside the corporation are concerned. This problem led to the "misappropriation dilemma" in the United States. If the misappropriation theory is not applied, most outsiders are not liable for insider trading. The main differences can be illustrated by resolving *O'Hagan* according to the German Securities Trading Act. However, the Supreme Court approved the misappropriation theory.

1. The facts of *O'Hagan*

Mr O'Hagan was a partner in the Minnesota law firm of Dorsey & Whitney, the local counsel of Grand Met. Grand Met was interested in acquiring Pillsbury. O'Hagan learned about the impending takeover through his employment at Dorsey & Whitney and purchased call options for Pillsbury stock. When Grand Met publicly announced its tender offer, O'Hagan exercised his call options, earning more than \$4 million. He was subsequently convicted of securities fraud, mail fraud, and money laundering. On the basis of the criminal conviction the SEC ordered O'Hagan to disgorge his profits. The Eighth Circuit did not apply the misappropriation theory, relieved O'Hagan of criminal liability and reimbursed his profits.

2. Outcome of *O'Hagan* under U.S. law^{cccxxv}

O'Hagan is not a traditional insider, because he is neither a director nor a (controlling) shareholder of the issuing corporation Pillsbury. O'Hagan is not a temporary insider pursuant to *Dirks* note 14 because he could only be a temporary insider regarding the corporation he works for. Therefore, O'Hagan could only be held liable under the misappropriation theory. Since the Supreme Court found the misappropriation theory valid and consistent with § 10(b) and Rule 10b-5, outsiders are liable if they misappropriate information in breach owed to the source of information and trade on the basis of such information. Therefore, if O'Hagan indeed misappropriated information he is liable.

3. *O'Hagan* under German law^{cccxxvi}

O'Hagan is liable as a primary insider if he received insider facts through (*aufgrund*) the proper performance of his profession (section 13 paragraph 1, number 3). O'Hagan was a lawyer when he received information which he used for securities transactions. Therefore, he received the information through his profession. He must have acquired the information "in the proper performance of his profession." The purpose of this requirement is to exclude persons who only accidentally receive knowledge of information. The Court stated that O'Hagan obtained confidential, material and nonpublic information through his employment at Dorsey & Whitney. Therefore, he obtained the knowledge in "the proper performance of his profession." Section 13 paragraph 1 next requires that the person obtain insider facts. O'Hagan must have obtained knowledge relating to an issuer of insider securities which has not been made public and which is capable of substantially influencing the stock price upon public disclosure

The knowledge in the *O'Hagan* case concerned a pending takeover. It was not disclosed to the public when O'Hagan traded. The requirement "capability" must be determined from an objective *ex post* perspective. This takeover can be considered to be capable influencing the price of Pillsbury stock. In this case the likelihood of change in the stock price became even a reality. Therefore, O'Hagan is a "primary insider" according to section 13 paragraph 1, number 3.

Furthermore, German insider trading law requires that O'Hagan have violated the insider trading prohibition regulated in section 14 of the Securities Trading Act. This requires O'Hagan to have purchased insider securities by taking advantage of his knowledge of "insider facts". O'Hagan purchased call option. According to section 12 in connection with section 2, paragraph 1 of the Securities Trading Act, call options are insider securities. When O'Hagan purchased these call options he acted intentionally and wanted to take advantage from his knowledge he obtained through his profession at Dorsey & Whitney. Therefore, O'Hagan violated the German insider prohibition regulated in section 14 paragraph 1, number 1 of the Securities Trading Act.

Conclusion

Insider trading requires regulation and should not be left to the market. Economic arguments against its regulation are highly speculative. Furthermore, unregulated insider trading may have detrimental effects for the securities market. The costs outweigh its benefits. Insider trading regulation is considered essential for the functioning of modern securities markets. Regulation is important to gain investor's confidence in the integrity of the securities market. Legislatures have been aware of the detrimental effects of insider trading and the significance of investors' confidence when regulating insider trading.

However, as shown in the comparison, the concepts of regulating insider trading differ. The German insider trading law is more far-reaching than the U.S. insider trading law with regard to parties standing outside the corporation. The German insider regulation does not require a relationship between the corporation and the insider. Section 13, paragraph 1, number 3 and section 14, paragraph 2 of the Securities Trading Act are likely to become the main "weapon" against insider trading in Germany.

The U.S. insider regulation is still based on the concept of fraud. However, the two complementary theories make sure that not only traditional insiders but also outsiders can be held liable under certain conditions.. The only way to reach persons like O'Hagan under the present law in the United States was to apply the misappropriation theory. Clearly, the statutory interpretation is very broad, however, it is the appropriate signal to the capital market. Otherwise, investor confidence could be endangered with dramatic economic consequences.

Only the future will show whether the decision of the Supreme Court on the validity of the misappropriation theory is enough to ensure the investor confidence in honest securities markets. Therefore, insider trading in securities will remain an issue for courts and scholars.

The United States used to be an example for insider regulation in other countries. Therefore, it will be interesting whether the United States will look at these countries now, which recently enacted insider regulation. The United States might get inspiration from those countries regarding the question how to extend liability to outsiders. Thus, in the age of global markets, comparative legal studies are becoming more significant.

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ⁱⁱ Bernhard Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and the European Community* 3 (1991).

ⁱⁱⁱ At about the same time in *Laidlaw v. Organ*, (15 U.S. 178, 2 Wheat.178, 4 L.Ed. 214 (1817)), the U.S. Supreme Court dealt with a case which arose when the buyer of tobacco received knowledge that the peace of Ghent had been signed by British and American commissioners. This news increased the value of tobacco from 30 to 50 cents. The court found that the buyer was not bound to communicate knowledge of extrinsic circumstances, which influenced the price of a commodity. However, the court came to this conclusion because "the means of intelligence [were] equally accessible to both parties." p.194. According to Siegfried Kümpel, *Bank- und Kapitalmarktrecht* (1995) 14.70 and Thomas Hoeren, *Selbstregulierung und Insiderrecht - Die Mitteilung des Centralverbandes des Deutschen Bank- und Bankiersgewerbes vom 12.10.1908*, ZBB 1993, 112, the first insider trading cases in Germany supposedly arose in the nineteenth century in connection with railway corporations.

^{iv} John C. Coffee Jr., *Hush!: The Criminal Status of Confidential Information after McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 Am. Crim. L. Rev. 121 (1988) states that insider trading is "the representative white-collar crime of the 1980's."

^v Ivan Boesky, an arbitrageur who traded illegally on the basis of inside information obtained through bribes, was allegedly fined \$100 million by the SEC. See Steven Brill, *Can Boesky's Sweetheart Plea Bargain Be Undone*, Am.Law., Dec. 1987, at 3, available in LEXIS, News Library, Amlawr File. Dennis Levine, a former executive at the investment banking firm of Drexel Burnham Lambert, paid \$11.6 million in settlement with the SEC in which Levine pled guilty to insider trading charges. See Barbara Bradley, *Feds Unleash Half of Assault on Drexel*, Christian Sci. Monitor, Sept, 19, 1988, at 1 available in LEXIS, News File, Arcnws File; George L. Fleming, *A Decade of Debt and Greed: Roaring '80's Draws*

Unsettling Parallels, St. Petersburg Times, Dec. 19, 1988, at 15, available in LEXIS, Regnws Library, Flwvs File. Cited according to John R. Beeson, *Rounding the Peg to fit the hole: A proposed regulatory reform of the misappropriation theory*, 144 U. Pa. L. Rev. 1077 n.4. (1996). A summary of the 1980's insider trading cases can also be found with Elizabeth Szockyj, *The Law and insider trading: In Search of a Level Playing field* 31 (1993). For a fascinating description of the insider trading scandals see the brilliant book James B. Stewart, *Den of Thieves* (1991).

^{vi} Freeman, SEC Litigation Release No. 13663, 1993 WL 190409 at 1.

^{vii} *United States v. O'Hagan*, 1997 WL 345229 (U.S.)

^{viii} *United States v. O'Hagan*, 92 F.3d 612 (8th Cir.1996).

^{ix} *Id.*

^x For a good international overview *see* Emmanuel Gaillard (ed.), *Insider trading : the laws of Europe, the United States and Japan* (1992).

^{xi} EC Insider Dealing Directive OJEC 18.11.89 No L 334/30; Literature describing the status and the development in Europe can be found in Klaus J. Hopt & Eddy Wymeersch (eds.), *European Insider Dealing: Law and Practice* (1991); Gerhard Wegen & Heinz-Dieter Assmann (eds.), *Insider Trading in Western Europe: Current Status* (1994).

^{xii} BGBI. I 1749 (1994).

^{xiii} This evaluation of Henry Manne's book can be found in Robert W. Hamilton, *Cases and Materials on Corporations: Including Partnerships and Limited Liability Partnerships* 977 (5th ed. 1994). Dennis W. Carlton & Daniel Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 n.1 (1983), think that this book is "brilliant" and that it is the starting point for anyone interested in the subject." Although the book is already 30 years old, this statement still seems to be true.

^{xiv} Henry G. Manne, *Insider Trading and the Stock Market* (1966).

^{xv} There is also recent economic and legal literature in Germany. For further references *see*, Klaus J. Hopt, *Ökonomische Theorie und Insiderrecht*, AG 1995, 353.

^{xvi} Alan R. Bromberg & Lewis D. Lowenfels, *Securities Fraud & Commodities Fraud*, § 7.4 (150) (1993) come to the conclusion: "We find none of the arguments wholly convincing. On balance we think insider trading is undesirable, but have reservations treating it as fraud."

^{xvii} Manne *supra* note 13, at 110.

^{xviii} For the separation of ownership and control *see* Adolph A. Berle Jr. & Means, Gardiner C., *The Modern Corporation and Private Property*, 64, 78-84, 113 (1932).

^{xix} Manne, *supra* note 13, at, 131-135.

^{xx} Manne, *supra* note 13 at, 131-133.

^{xxi} Manne, *supra* note 13 at, 110.

^{xxii} Carlton & Fischel, *supra* note 13, at 870-872.

^{xxiii} Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency costs and ownership structure*, 3 J. Fin. Econ. 305, 308. (1976) quoted in Mark Klock, *Mainstream Economics and the Case for Prohibiting Inside Trading*, 10 Ga. St. U. L. Rev. 297, note 107(1994).

^{xxiv} Carlton & Fischel, *supra* note 12, at 857.

^{xxv} Carlton & Fischel, *supra* note 12, at 870.

^{xxvi} Manne, *supra* note 13, 120.

^{xxvii} Carlton & Fischel, *supra* note 12, at 872.

^{xxviii} Carlton & Fischel, *supra* note 12, at 869, 875-876.

^{xxix} For a general overview of arguments both against and in favor of a regulation also See Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. Fla. L. Rev. 35 (1986).

^{xxx} R.H. Coase, *The Problem of Social Cost*, 3 J. L. Econ. 1 (1960).

^{xxxi} Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of corporate law* 254-255 (1991).

^{xxxii} Klock, *supra* note 22, at 316-317.

^{xxxiii} *Id.*

^{xxxiv} Bainbridge, *supra* note 28, at 47.

^{xxxv} Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1455 (1967).

^{xxxvi} Stephen Bainbridge, *supra* note 28, at 48.

^{xxxvii} Compare Manne, *supra* note 13, at 118 with Henry G. Manne, *In Defense of Insider Trading*, 44 Harv. L. Rev. 113, 119 (1966).

^{xxxviii} Robert W. Hamilton, *Fundamentals of Modern Business: A Lawyer's Guide*, 727 (1989 & 1996 supplement with Richard A. Booth).

^{xxxix} *Id.* In the recent insider case of *O'Hagan* the defendant also purchased call options (United States v. O'Hagan 92 F.3d 612 (8th Cir.1996)) *supra* note 7.

^{xl} Hans-Bernd Schäfer & Claus Ott, *Economic Effects of EEC Insider Trading Regulation Applied to Germany*, 12 Int'l Rev. & Econ. 357, 362 (1992).

^{xli} Bainbridge, *supra* note 28, at 50

^{xlii} Schäfer & Ott, *supra* note 39, at 362 citing Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 3 (1980).

^{xliii} Schäfer & Ott, *supra* note 39, at 363.

^{xliv} Saul Levmore, *Securities and Secrets : Insider Trading and the Law of Contracts*, 68 Va. L. Rev. 117, 149-151 (1982); Schotland, *supra* note 34, at 1448-1449.

^{xlv} Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich. L. Rev. 1051, 1053-60 (1982); Bainbridge, *supra* note 28, at 50.

^{xlvi} Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 11 Supreme Court Rev. 309, 332 (1981).

^{xlvii} Kenneth E. Scott, *Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy*, J. Leg. Stud. 9, 801, 808 (1980).

^{xlviii} Easterbrook, *supra* note 45, at 332.

^{xlix} *Id.*

¹ Louis Loss & Joel Seligman, *Securities Regulation* (3d ed. 1991 and 1996 supplement) 1461, preferring stock options.

^{li} Schäfer & Ott, *supra* note 39, at 366-368.

^{lii} Levmore, *supra* note 43; 149; Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)* 58 Fordham L. Rev. 309, 318 (1989); Steven R. Salbu, *Tipper credibility, noninformational tippee trading, and abstention from trading: An Analysis of Gaps in the Insider Trading Laws*, 68 Wash. L. Rev. 307, 326 (1993).

^{liii} Claus Schäfer & Hans-Bernd Ott, *Ökonomische Auswirkungen der EG-Insider-Regulierung in Deutschland*, ZBB 1991, 226, 233.

^{liv} Posner, Richard A. Posner, *Economic Analysis of Law* 417 (4th ed. 1992).

^{lv} Easterbrook, *supra* note 45, at 322.

^{lvi} Carlton & Fischel, *supra* note 12, at 876.

^{lvii} *See also* Bainbridge, *supra* note 28, at 52.

^{lviii} Frank H. Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1170-1171 (1981).

^{lix} Klock, *supra* note 22, at 314.

^{lx} Wolfgang Weber, *Insider-Handel, Informationsproduktion und Kapitalmarkt- Eine institutionenökonomische Analyse* 184 (1994), Schäfer & Ott, *supra* note 39, at 368.

^{lxi} Klaus J. Hopt, *supra* note 14, at 356.

^{lxii} Levmore, *supra* note 43, at 149-150; Marleen A. O'Connor, *supra* note 51, at 318.

^{lxiii} Steven R. Salbu, *supra* note 51, at 326.

^{lxiv} Scott, *supra* note 46, at 808.

^{lxv} Saul Levmore, *supra* note 43, at 149.

^{lxvi} Loss & Joel Seligman, *supra* note 49, at 3199.

^{lxvii} Robert W. Hamilton, *supra* note 37, at 729.

^{lxviii} *Id.*

^{lxix} Klaus J. Hopt, *Europäisches und deutsches Insiderrecht*, ZGR 1991, 17, 24.

^{lxx} Klock, *supra* note 22, at 313;

^{lxxi} Harold Demsetz, *Corporate Control, Insider Trading, and Rate of Return*, 76 Am. Econ. Rev. 313 (1986).

^{lxxii} *Id.*, at 316.

^{lxxiii} *Id.*

^{lxxiv} Kai Lahmann, *Insiderhandel, Ökonomische Analyse eines ordnungspolitischen Dilemmas* 109 n. 263 (1993).

^{lxxv} For critical comments also *see*, Peter Schörner, *Gesetzliches Insiderhandelsverbot. eine ordnungspolitische Analyse* 243-246(1991).

^{lxxvi} Manne, *supra* note 13, at 133.

^{lxxvii} Klaus J. Hopt, *supra* note 14, at 356.

^{lxxviii} Hartmut Schmidt, *Disclosure, Insider Information and Capital Market Functions*, in: *Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* 339 (Klaus J. Hopt & Gunther Teubner eds 1985). Schmidt thinks that "[t]his fund raising function, although most important, is overlooked at times in sophisticated discussions of capital market policy."

^{lxxix} *Id.*

^{lxxx} Christopher Paul Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industries*, 29 Stan. L. Rev. 1031 n.1 (1977).

^{lxxxi} Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 384-385 (1970). *See* the example of John R. Beeson, *supra* note 4, at 1085: "[I]f a share of Pepsi Co. is trading for \$ 36, that price is the true value of Pepsi given all information known about Pepsi Co's business prospects and growth opportunities."

^{lxxxii} James D. Cox, *Financial Information, Accounting, and The Law* 181, 183-188 (1980), reprinted in Lewis D. Solomon et al. *Corporations, law and policy, materials and problems* 901-915 (3d ed. 1994

^{lxxxiii} Beeson, *supra* note 4, at 1086.

^{lxxxiv} *Id.*

^{lxxxv} James H. Lorie & Mary Hamilton, *the Stock Market: Theories and Evidence* 97 (1973) quoted in Beeson *supra* note 4, n.44.

^{lxxxvi} Loss & Seligman, *supra* note 49, at 185 n.41.

^{lxxxvii} Fama, *supra* note 80, at 409-413.

^{lxxxviii} Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 *Yale L.J.* 577, 610 (1992); *See also* Robert W. Hamilton, *Fundamentals of Modern Business: A Lawyer's Guide*, *supra* note 37, at 649.

^{lxxxix} 485 U.S. 224, 246, 247 especially note 24 (1988). However, we have to be aware that *Basic v. Levinson* is not a leading case and that it was only a 4 to 2 decision in which Justice Scalia, Justice Kennedy and Justice Rehnquist took no part.

^{xc} Robert W. Hamilton, *Fundamentals of Modern Business: A Lawyer's Guide*, *supra* note 37, at 649

^{xcⁱ} *Id.* at 649-650.

^{xcⁱⁱ} Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 *Hofstra L. Rev.* 127, 133 (1984).

^{xcⁱⁱⁱ} *Id.*

^{xc^{iv}} *Id.* "Because other market participants can observe trading by insiders, albeit imperfectly, prices will move in the direction that the new information implies."

^{xc^v} Manne, *supra* note 13, at 78-104.

^{xc^{vi}} Harry Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 *Bus. Law* 517, 533 (1982).

^{xc^{vii}} Schäfer & Ott, *supra* note 52, at 227-228.

^{xc^{viii}} Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Theory and Signalling Theory*, in: *Issues in financial regulation*, 177, 181 (Franklin R. Edwards ed., 1979).

^{xc^{ix}} Schotland, *supra* note 34, at 1443.

^c *See* Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 *J. Fin. Econ.* 1141 (1976).

^{ci} Givoly & Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence*, 58 *J. Bus.* 69 (1985) quoted in Bainbridge *supra* note 28, n. 84.

^{cⁱⁱ} *See also* Bainbridge, *supra* note 28, at 45.

^{cⁱⁱⁱ} *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanism of Market Efficiency*, 70 *Va. L. Rev.* 549, 629.

^{c^{iv}} *Id.*

^{c^v} *Id.*

^{cvi} *Id.*

^{cvii} *Id.*

^{cviii} *Id.*

^{cix} *Id.*

^{cx} William J. Carney, *Signalling and Causation in Insider Trading*, 36 Cath. U. L. Rev. 863, 885-891 (1987).

^{cxⁱ} Scott, *supra* note 46, at 810-811. *See also* Easterbrook, *supra* note 45, at 327 agreeing generally with Scott but questioning Scott's view that it depends on whether the news is good or bad.

^{cxⁱⁱ} Gilson & Kraakman, *supra* note 102, at 631.

^{cxⁱⁱⁱ} Dennis S. Corgill, *Insider Trading, Price Signal, and Noisy Information*, 71 Ind. L. J. 355, 359, 415, 417 (1996) calls these reasons "nonfinancial reasons."

^{cx^{iv}} Christopher Paul Saari, *supra* note 79, at 1031 n.1 (1977).

^{cx^v} Morris Mendelson, *The Economics Board of Insider Trading Reconsidered*, 117 U. Pa. L. Rev. 470, 473-477 (book review) (1969).

^{cx^{vi}} *Id.*

^{cx^{vii}} Haft, *supra* note 44, at 1051.

^{cx^{viii}} Bergmans, *supra* note 1, at 108 citing James Cox, *Insider Trading and Contracting: A critical Look to the "Chicago School" ?*, Duke L.J. 628, 637, 641 (1986).

^{cx^{ix}} Loss & Seligman, *supra* note 49 at, 762.

^{cx^x} Mendelson, *supra* note 114, at 473-477 (1969).

^{cx^{xi}} Hartmut Schmidt, *Insider Regulation and the Economic Theory*, in *European Insider Dealing 27 supra* note 10.

^{cx^{xii}} *Id.*, at 26.

^{cx^{xiii}} *Id.*, at 26-27.

^{cx^{xiv}} *Id.*

^{cx^{xv}} Icmán Anabtawi, *Toward a Definition of Insider Trading*, 41 Stan. L. Rev. 377, 397 (1989).

^{cx^{xvi}} Schmidt, *supra* note 120, at 25.

^{cx^{xvii}} Solomon, *supra* note 81, at 912.

^{cx^{xviii}} *Id.*

^{cxxix} William K.S. Wang & Marc I. Steinberg, *Insider Trading* 34-35 (1996) citing Mendelson, *supra* note 114 at 477-478, Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law*, 93 Harv. L. Rev. 322, 355-356 (1979); Klock, *supra* note 22, at 330, 335; and Boyd Kimbal Dyer, *Economic Analysis, Insider Trading and Game Markets*, 1992 Utah L. Rev. 1, 62-64.

^{cxxx} George A. Akerlof, *The Market For "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

^{cxxxi} *Id.* at 489.

^{cxxxii} Klock, *supra* note 22, at 330-331, 335.

^{cxxxiii} Klock, *supra* note 22, at 329.

^{cxxxiv} Michael Manove, *The Harm From Insider Trading and Informed Speculation*, 104 Q. J. Econ. 823, (1989).

^{cxxxv} Cox, *supra* note 117, at 649.

^{cxxxvi} *See* Section 15 of the German Securities Trading Act, so-called "*Ad-hoc-disclosure*" (*Ad-hoc-Publizität*).

^{cxxxvii} *See* Donald C. Langevoort, *Insider Trading Regulation, Enforcement & Prevention* § 1.02 [4] (1996): "Descriptively, most people who oppose insider trading seem to believe that quite apart from any harm caused to specific investors, insider trading is simply unfair exploitation of information that properly belongs to someone else."

^{cxxxviii} Michael Manove, *supra* note 133, at 824.

^{cxxxix} Schäfer & Ott, *supra* note 39, at 363.

^{cxl} *Id.* (citing Harold Demsetz, *supra* note 70, at 316.)

^{cxli} Schäfer & Ott, *supra* note 39, at 363.

^{cxlii} *In Re Cady Roberts & Co.*, 40 S.E.C. 907, 912 (1961). President Franklin D. Roosevelt justified the securities legislation by saying: "It should give impetus to honest dealing and thereby back public confidence" - Congressional Record 937 (March 29, 1933).

^{cxliii} *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 150 (1984).

^{cxliv} *O'Hagan* 1997 WL 345229, 10 (U.S.)

^{cxlv} The Supreme Court states: "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." 1997 WL 345229, 10 (U.S.).

^{cxlvi} Brudney, *supra* note 128, at 335. This assumption is questioned by Charles C. Cox & Kevin S. Fogarty, *Bases for Insider Trading Law*, 49 Ohio St. L. J. 353, 354: "Perhaps the economic argument most frequently invoked (though not often by economists) against insider trading is that investors will desert the securities markets if they believe other market participants hold an unfair informational advantage. This

argument is plausible but has never been systematically studied. Nor has it been confirmed by casual observation. We do not know how investors would react to a market where insider trading was entirely open and widespread; however, stock markets functioned successfully --whether or not optimally we cannot say-- long before insider trading prosecutions became as common as they have in the last twenty-five years".

^{cxlvii} Beeson, *supra* note 4, at 1098 n.106: "When enacting the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress noted that the 'Committee views these steps as an essential ingredient in a program to restore the confidence of the public in the fairness and integrity of our securities markets....Small [investors] will be reluctant to invest in the market if [they] feel [] it is rigged against [them]' " citing H.R. Rep. No. 910, 100th Cong., 2d Sess. 7-8 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6044-45.

^{cxlviii} Brudney, *supra* note 128, at 346, 354-360-363.

^{cxlix} See Bergmans, *supra* note 1, at 111-112.

^{cl} Cox & Fogarty, *supra* note 145, at 354; Carney, *supra* note 110, at 863, 898.

^{cli} Cox & Fogarty, *supra* note 145, at 354.

^{clii} This expression derives from a translation in a German article Mathias Magnus, *Insidergeschäfte und Regelungsbedarf aus ökonomischer Sicht*, ZKW 1994, 543-545.

^{cliii} *Id.*

^{cliv} OJEC 18.11.89 No L 334/30.

^{clv} H.R. Rep. 910, 100th Cong., 2d Sess. 7-8 (1988): "Insider trading damages the legitimacy of the securities markets and diminishes the public's faith. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities."

^{clvi} However, these economic advantages can be questioned itself.

^{clvii} For further reference see William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom under SEC Rule 10b-5*, 54 S. Cal. L. Rev 1217 (1981) and the interesting approach of Bergmans, *supra* note 1, at. 115 who distinguishes between the situation of the individual shareholder and the effects of all investors as a group.

^{clviii} *Id.*

^{clix} Donald C. Langevoort, *Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace* 16 Hastings Int'l & Comp. L. Rev. 175, 182 (1993) "For most contemporaneous traders in the stock market, the presence of some insider buying or selling with an informational advantage does not cause any pecuniary harm. In all likelihood, they would have traded anyway, at roughly the same price. No doubt the insight that any harm from insider trading is extremely diffuse has much to do with the emphasis on public rather than private enforcement."

^{clx} Dooley, *supra* note 42, at 55.

^{clxi} Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. Rev 547, 565 (1970) [Cited as law Professors].

^{clxii} Norman S. Douglas, *Insider Trading: The Case Against the Victimless Crime Hypothesis*, 23 Fin. Rev. 127 (1988).

^{clxiii} Bergmans, *supra* note 1, at 115.

^{clxiv} Wang, *supra* note 156, at 1235-1237.

^{clxv} Mendelson, *supra* note 114, at 475-476.

^{clxvi} For a description of trading in the opposite direction, *see* Bergmans, *supra* note 1, at 115.

^{clxvii} Manne, *Law Professors*, *supra* note 160, at 548.

^{clxviii} Klock, *supra* note 22, at 304.

^{clxix} Manne, *supra* note 13, at 61: "The insiders' gain is not made at the expense of anyone. The occasionally voiced objection to insider trading - that someone must be losing the specific money the insiders make - is not true in any relevant sense".

^{clxx} Klock *supra* note 22, at 305.

^{clxxi} Edwin Mansfield, *Microeconomics: Theory and Applications* 438-439 (1988) quoted after Klock, *supra* note 22, n. 48.

^{clxxii} John Maynard Keynes, *The General Theory of Employment, Interest and Money* 151 (1936).

^{clxxiii} Klock, *supra* note 22, at 304 citing Lawrence M. Ausubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1036 (1990); and Manove, *supra* note 133, at 824.

^{clxxiv} Manne, *Law Professors*, *supra* note 160, at 551.

^{clxxv} Klock, *supra* note 22, at 306.

^{clxxvi} This is the distinction which underlies Bergman's observations on economic harm of investors, *supra* note 1, at 115.

^{clxxvii} Wang, *supra* note 156, at 1234.

^{clxxviii} *Id.*, at 1235.

^{clxxix} *Id.*

^{clxxx} *Id.*, at 1222-1223.

^{clxxxi} *Id.*

^{clxxxii} *Id.*

^{clxxxiii} *See* Klaus J. Hopt, *Ökonomische Theorie und Insiderrecht*, *supra* note 14, at 355 who comes to the same conclusion that the harm to investor is not economically convincing.

^{clxxxiv} This mistake can be observed in the German Insider Discussion.

^{clxxxv} KümpeL, *supra* note 2, at 14.92 (1995). For the separation between protection of the individual investor and the investors as a group *see* KümpeL, at 14.27.

^{clxxxvi} Wang & Steinberg, *supra* note 128, at 391-437

^{clxxxvii} Wang & Steinberg, *supra* note 128, at 18, come to the same conclusion.

^{clxxxviii} Bergmans, *supra* note 1, at 7-8.

^{clxxxix} For a short overview about the common law approach *see*: Bergmans, *supra* note 1, at. The majority view of common law denied that corporate officers and directors owe fiduciary duties to shareholders.

^{cx} 15 U.S.C. § 78 j(b) (1994)

^{cxci} 17 C.F.R. § 240.10b-5.

^{cxcii} Wade M. Hall, *Insider Trading Liability: Are We Ready to Leave the Misappropriation Theory Quagmire?*, 44 U. Kan. L. Rev. 867, 869 (1996).

^{cxci} *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d. 833, 859 (2d Cir. 1968).

^{cxci} *In re Cady, Roberts & Co.* 40 S.E.C. 907 (1961).

^{cxv} *Chiarella v. United States*, 445 U.S. 222 (1980).

^{cxvi} *Dirks v. United States*, 463 U.S. 646 (1983).

^{cxvii} According to Loss & Seligman, *supra* note 49, at 3584 the term "traditional insiders" includes the following groups: (1) directors and officers; (2) controlling persons; (3) employees; spouses, members of at least immediate family trusts; and (5) issuers when repurchasing their own stock.

^{cxviii} *In re Cady, Roberts & Co.* 40 S.E.C. 907 (1961).

^{cxix} *In re Cady, Roberts & Co.* 40 S.E.C. 912.

^{cc} 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971). In the *Texas Gulf Sulphur* case Texas Gulf Sulphur Co. performed exploratory drilling on a tract of land in eastern Canada. The drilling results, which showed substantial deposits of copper, zinc, and silver, were very good. The Second Circuit held that a geologist employed by Texas Gulf Sulphur & Co. had detailed knowledge of a certain drilling and told certain outside individuals that Texas Gulf Sulphur Co. "was a good buy". These individuals thereafter acquired Texas Gulf Sulphur Co. stock and calls. The Appellate Court of the Second Circuit held that Section 10(b) of the Securities Exchange Act and Rule 10b-5 required persons having such access to information for a corporate purpose either to disclose it to public investors before acting on it for their personal benefit or to abstain from trading in or recommending the stock while the information remained undisclosed. The Court stated that Rule 10b-5 "is based in policy on the justifiable expectation of the securities marketplace that all investors have relatively equal access to material information."

^{cci} *Texas Gulf Sulphur & Co.*, 401 F.2d at 848.

^{ccii} Reinier Kraakman, *The Legal Theory of Insider Trading Regulation in the United States in: European Insider Dealing* (Hopt/Wymeersch eds., 1991).

^{cciii} 445 U.S. 222 (1980). For Chief Justice Burger's opinion see text accompanying Fn. 227 and 228.

^{cciv} *Chiarella v. United States*, 445 U.S. 222 at 227-228; Hall, *supra* note 191, at 871.

^{ccv} *Chiarella v. United States*, 445 U.S. at 230.

^{ccvi} Kraakman, *supra* note 201, at 42.

^{ccvii} *Dirks v. United States*, 463 U.S. 646 (1983).

^{ccviii} *Dirks*, 463 U.S., at 655 n. 14.

^{ccix} *Id.*

^{ccx} *Id.*

^{ccxi} Wang & Steinberg, *supra* note 128, at 286.

^{ccxii} *Dirks v. United States*, 463 U.S. 646 (1983). Before *Dirks*, case law held that a tipper was held liable even if he or she does not trade. The court in *Texas Gulf Sulphur Co.* *supra* note 199 held that persons violated that Rule not only by trading on the basis of inside information but also by 'tipping' the information to others, since one who may not himself trade in securities without disclosing information known to him may not pass that information to others for their use in securities transactions. After having persuaded the Second Circuit in *Texas Gulf Sulphur & Co.* that the non-trading tipper as well as the trading tippee can violate Rule 10b-5, the Commission next brought an administrative proceeding against Merrill Lynch (*Merrill Lynch, Pierce, Fenner & Smith, Inc.* 43 SEC 933 (1968)). Here a prospective managing underwriter was given material information with regard to a substantial decline in recent earnings and downward revision of earnings estimates by the issuer for use in connection with the proposed public offering. This highly significant information was entrusted to registrant by virtue of its business relationship with the issuer before it was publicly available. It was passed on by the registrant to certain of its customers prior to its dissemination to the public. These persons were held liable as tippers. The same incident resulted in a Second Circuit decision that held Merrill Lynch liable as a tipper to persons who had bought Douglas stock in the market during the same period (*Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 495 F.2d 228 (2d Cir. 1974)). In this case, the Second Circuit decided whether Merrill Lynch violated Section 10(b) and Rule 10b-5 acting as a professional underwriter of a Douglas debenture issue. Also at issue, whether some of the officers, directors and employees of Merrill Lynch violated then, when they divulged material adverse inside information regarding Douglas' earnings to some customers. The customers sold Douglas common stock, without disclosing that they were in possession of an inside information. As a result of the trading, Merrill Lynch received commissions and other compensations. The Court held that Section 10(b) and Rule 10b-5 were violated using the same argument as in *SEC v. Texas Gulf Sulphur Co.* where it stated that "...anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."

^{ccxiii} *Dirks*, 463 U.S. at 664.

^{ccxiv} *Id.*, at 661.

^{ccxv} *Id.* at 663.

^{ccxvi} *Dirks*, 463 U.S. at, 662.

^{ccxvii} *Dirks*, 463 U.S. at 655 note14.

^{ccxviii} Wang & Steinberg, *supra* note 128, at 292.

^{ccxix} *Id.*

^{ccxx} Wang & Steinberg, *supra* note 128, at 295 referring to *Dirks*, where Secrist was no longer employed by the issuer.

^{ccxxi} Wang & Steinberg, *supra* note 128, at 297-302. Wang & Steinberg also mention that there are authors who question their assumption and who think that the issuer has a fiduciary duty only to the shareholders as a group.(See at 299-300).

^{ccxxii} Wang & Steinberg, *supra* note 128, at 302.

^{ccxxiii} Joseph T. McLaughlin & Margaret A. Helen McFarlane, *United States of America, in: Insider Trading*, *supra* note 9, at 290.

^{ccxxiv} Wang & Steinberg, *supra* note 128, at 310.

^{ccxxv} Wang & Steinberg, *supra* note 128, at 310 referring to *Feldman v. Simkins Indus. Inc.* (679 F.2d. 1299, 1304 (9th Cir. 1982) held that a shareholder of 14 percent is not an insider.

^{ccxxvi} *Loss & Seligman*, *supra* note 49, at 3588.

^{ccxxvii} *Id.*

^{ccxxviii} *Chiarella*, 445 US. at 228.

^{ccxxix} *Chiarella*, 445 U.S. at 240 (C.J. Burger dissenting).

^{ccxxx} *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990).

^{ccxxxi} *Carpenter v. United States* 484 U.S. 19 (1987).

^{ccxxxii} *United States v. Chestman* 947 F.2d 551 (2d Cir. 1991).

^{ccxxxiii} *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

^{ccxxxiv} *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991).

^{ccxxxv} *United States v. Bryan*, 58 F.3d. 933 (4th Cir. 1995).

^{ccxxxvi} *United States v. O'Hagan* 92 F.3d 612 (8th Cir.1996).

^{ccxxxvii} *O'Hagan* 1997 WL 345229 (U.S.).

^{ccxxxviii} *Bergmans*, *supra* note 1, at 19; *Laughlin/McFarlane*, *supra* note 222, at 285.

ccxxxix 426 U.S. 438 (1976).

ccxl *Id.* at 449.

ccxli 485 U.S. 224 (1988).

ccxlii *Id.* at 238 (citing *Texas Gulf Sulphur*, 401 F.2d at 849.)

ccxliii Donald C. Langevoort, *Insider Trading Handbook*, 126 et seq., 133 (1986).

ccxliv Wang & Steinberg, *supra* note 128, at 129.

ccxlv *Id.* citing Bromberg & Lowenfels, *supra* note 15, § 7.4 (482).

ccxlvii Bromberg & Lowenfels, *supra* note 15, § 7.4 (400).

ccxlviii *See also* In the matters of Investors Management Co., Inc. 44 SEC 633, 644-645 (1971): Information is nonpublic when it has been disseminated in a manner making it available to investors generally.

ccxlix *Texas Gulf Sulphur*, 401 F.2d at 854.

cccl *Bromberg & Lowenfels, supra* note 15, § 7.4 (400) citing Gilson & Kraakman, *supra* note 102, at 560-572.

cccli Wang & Steinberg, *supra* note 128, at 166 citing Bromberg & Lowenfels, *supra* note 15, § 7.4 (482).

ccclii Bromberg & Lowenfels, *supra* note 15., § 7.4 (400).

cccliii Wang & Steinberg, *supra* note. 128, at 166.

cccliv *Id.*

ccclv Langevoort, *Insider Trading Regulation, supra* note 136, § 1.02 [4]; Bergmans, *supra* note 1, at 26 referring to *In re Apple Computer Securities Regulation, Schneider et al. v. Vermand et al.* 886 F.2d. 1109, 1117 (9th Cir. 1989).

ccclvi *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

ccclvii Darius M. Budzen and Aia M. Frankowska, *Prohibitions Against Insider Trading in the United States and the European Community: Providing Guidance for Legislatures for Eastern Europe*, 12. B. U. Int'l L. J. 92, 106 (1996) citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 note 12.

ccclviii For further reference *see* Bergmans, *supra* note 1, at 27.

ccclix SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

ccclx *Dirks*, 463 U.S. at 660.

ccclxi Wang & Steinberg, *supra* note 128, at 192.

ccclxii Superintendent of Life Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971).

cclxii 1997 WL 345229, 8 (U.S.).

cclxiii *Id.* Courts relying upon the misappropriation theory state that section 10(b) contains no requirement that the fraud is committed against the purchaser or seller of securities, but rather that a fraudulent scheme is directly related to the trading process (United States v. Newman, 664 F.2, 12, 18. But *see also United States v. Bryan*, 58 F3d. 933,945-946. This paper cannot go into detail whether the "in connection with" requirement is satisfied and can give further references: Timothy J. Horman, *In Defense of United States v. Bryan: Why the misappropriation theory is indefensible*, 64 Fordham L. Rev. 2455, 2495, 2496 (1996). Other recent articles discussing the misappropriation theory: Hall, *supra* note 191; Troy Cichos, *The Misappropriation Theory of Insider Trading: Its Past, Present, and Future*, 18 Seattle U. L. Rev. 389 (1995); Jay G. Mervin, *Misappropriation Theory Liability Awaits a Clear Signal*, 51 Bus. Law. 803 (1996).

cclxiv 1997 WL 345229, 9 (U.S.).

cclxv The Insider Trading Guidelines are reprinted in Klaus J. Hopt & Michael R. Will, *Europäisches Insiderrecht M-100* (1973).

cclxvi Baumbach & Hopt, HGB [16], Einl. Anm. 2.B (24th ed. 1995). In the Steinkühler case, the member of the supervisory board was not liable because he was not subject to the "Insider Trading Guidelines". Shortly after this case the new insider law was enacted. However, the Steinkühler case was not a reason for the enactment of the German Securities Trading Act. The bill was already under consideration way when this case arose.

cclxvii Gottfried Walter, *Erfahrungen mit den Insider-Regeln*, in: *Festschrift für Winfried Werner*, 933 (Walter Hadding, et al. eds. 1984)

cclxviii Hopt, *Europäisches Insiderrecht*, *supra* note 68.

cclxix Aline Sullivan, *Need for Foreign Capital Prods European Reforms*, Int'l Herald Trib., Oct. 1, 1994 cited after Ursula C. Pfeil, *Finanzplatz Deutschland: Germany Enacts Insider Trading Legislation*, 11 Am. U. J. Int'l & Pol'y 137, 138 (1996): "The investing community in Germany and the world-at-large were aware of the widespread insider trading practice in Germany and acted accordingly: investors generally played the German equity market if they were insiders and invested elsewhere if they were not.

cclxx This is the translation according to Donald C. Langevoort, *supra* note 136, § 14.04 [3]. However, we find also the term Wertpapierhandelsgesetz translated as Securities Trade Act, Martin Peltzer & Paul Scesniak, *German Securities Trade Act, German-English Text with an Introduction in English* (1995).

cclxxi The Council is the main legislative organ of the European Union.

cclxxii Council Directive 89/502, OJEC 18.11.1989 No L 334/30.

cclxxiii The Council is the main legislative organ of the European Union. Each member state is represented in the Council by its respective minister (Art. 146 of Treaty of Rome) .

cclxxiv Art. 100a only requires a qualified majority which are 54 of 74 votes in the Council.

cclxxv Heinz-Dieter Assmann, before § 12 Rz. 10 in: *Wertpapierhandelsgesetz* (Dieter Assmann & Uwe H. Schneider eds., 1995).

cclxxvi Bundesrats-Drucksache 585/94 of July 8, 1994. (Reports of the German upper chamber).

^{cclxxvii} The English translation will be given in quotation marks followed by the German expression in parentheses.

^{cclxxviii} (1) *Insiderpapiere sind Wertpapier, die*

an einer inländischen Börse zum Handel zugelassen oder in den Freiverkehr einbezogen sind, oder in einem anderen Mitgliedstaat der Europäischen Gemeinschaften oder einem anderen Vertragsstaat des Abkommens über den Europäischen Wirtschaftsraum zum Handel an einem Markt im Sinne des § 2 Abs. 1 zugelassen sind.

Der Zulassung zum Handel an einem Markt im Sinne von § 2 Abs. 1 oder der Einbeziehung in den Freiverkehr steht es gleich, wenn der Antrag auf Zulassung oder Einbeziehung gestellt oder öffentlich angekündigt ist.

(2) *Als Insiderpapiere gelten auch*

Rechte auf Zeichnung, Erwerb oder Veräußerung von Wertpapieren,

Rechte auf Zahlung eines Differenzbetrages, der sich an der Wertentwicklung von Wertpapieren bemißt,

Terminkontrakte auf einen Aktien- oder Rentenindex oder Zinsterminkontrakte (Finanzterminkontrakte) sowie Rechte auf Zeichnung, Erwerb oder Veräußerung von Finanzterminkontrakten, sofern die Finanzterminkontrakte Wertpapiere zum Gegenstand haben oder sich auf einen Index beziehen, in den Wertpapiere einbezogen sind,

sonstige Terminkontrakte, die zum Erwerb oder zur Veräußerung von Wertpapieren verpflichten,

wenn die Rechte oder Terminkontrakte in einem Mitliestaat der Europäischen Gemeinschaften oder in einem anderen Vertragsstaat des Abkommens über den den Europäischen Wirtschaftsraum zum Handel an einem Markt im Sinne des § 2 Abs. 1 zugelassen oder in den Freiverkehr einbezogen sind und die in den Nummern 1 bis 4 genannten Wertpapiere in einem Mitgliedstaat des Abkommens über den Europäischen Wirtschaftsraum zum Handel an einem Markt im Sinne des § 2 Abs. 1 zugelassen oder in den Freiverkehr einbezogen sind. Der Zulassung der Rechte oder Terminkontrakte zum Handel an einem markt im Sinne des § 2 Abs. 1 oder ihrer Einbeziehung in den Freiverkehr steht es gleich, wenn der Antrag auf Zulassung oder Einbeziehung gestellt oder öffentlich angekündigt ist.

^{cclxxix} *Wertpapiere im Sinne dieses Gesetzes sind, auch wenn für sie keine Urkunden ausgestellt sind,*

1. Aktien, Zertifikate, die Aktien vertreten, Schuldverschreibungen, Genußscheine, Optionsscheine,

2. andere Wertpapiere, die mit Aktien oder Schuldverschreibungen vergleichbar sind,

wenn sie auf einem Markt gehandelt werden können, der von staatlich anerkannten Stellen geregelt und überwacht wird, regelmäßig stattfindet und für das Publikum unmittelbar oder mittelbar zugänglich ist.

^{cclxxx} This is not a literal translation. The provision is paraphrased.

^{cclxxx} *Jede nicht öffentlich bekannte Tatsache, die sich auf einen oder mehrere Emittenten von Insiderpapieren bezieht und die geeignet ist, im Falle ihres öffentlichen Bekanntwerdens den Kurs der Insiderpapiere erheblich zu beeinflussen.*

^{cclxxxii} Klaus J. Hopt, *Das neue Insiderrecht nach §§ 12 ff WpHG - Funktion, Reichweite, Dogmatik, in : Das Zweite Finanzmarktförderungsgesetz in der praktischen Umsetzung - Bankrechtstag 1995 8* (Walther Hadding, Klaus J. Hopt, Herbert Schimansky eds., 1996).

^{cclxxxiii} This is the official view of the German legislature BT-Drucks. 12/6679, p. 46. The German legislature referred to it as "Bereichsöffentlichkeit."

^{cclxxxiv} *Id.*

^{cclxxxv} *Id.*

^{cclxxxvi} *Id.*, "*allgemein zugängliche Informationssysteme*".

^{cclxxxvii} Hopt, *Das neue Insiderrecht*, *supra* note 281, at 13.

^{cclxxxviii} *Id.*, at 14.

^{cclxxxix} *Id.*

^{ccxc} *Id.*

^{ccxci} BT-Drucks. 12/6679, p.47. The terms and conditions of the stock exchanges require that changes in stock prices of 5% to 10% are announced.

^{ccxcii} BaWe, Keine Lücken bei Insideruntersuchungen, (February, 20, 1997)
<http://www.bawe.de/pm2_97.htm>.

^{ccxciii} Hopt, *Das neue Insiderrecht*, *supra* note 281, at 8.

^{ccxciv} *See* Bergmans (regarding "primary" and "secondary insiders" pursuant to the EC-Insider Trading Directive), *supra* note 1, at 69.

^{ccxcv} Carsten P. Claussen, Insiderhandelsverbot und Ad hoc-Publizität 10 (1996).

^{ccxcvi} EC-Insider Dealing Directive, Art. 2 (1) .

^{ccxcvii} "The German system of corporate governance is often described as an alternative model to that which is customary in the Anglo-Saxon world. At the heart of the German model is a two-tier board of directors. One board actively manages the business and affairs of the company, while the other board, elected in part by shareholders and in part by labor, is responsible for the supervision of the management board". (Thomas J. Andre Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 Tul. L. Rev. 1819 (1996)). (The paper uses the expression "board of management" for the board which actively manages the business (*Vorstand*), the expression "supervisory board" is used for the board which is responsible for the supervision (*Aufsichtsrat*)).

^{ccxcviii} This is not a literal translation, but rather a paraphrased translation. *Insider ist, wer als Mitglied des Geschäftsführungsorgans oder als persönlich haftender Gesellschafter des Emittenten oder eines mit dem Emittenten verbundenen Unternehmens. . .* (sec. 13 p.1 No.1).

^{ccxcix} Klaus J. Hopt, *Das neue Insiderrecht nach §§ 12 ff WpHG*, *supra* note 281, at 8.

^{ccc} Securities Trading Act § 13 (1) No 1.

^{ccc}_i Assmann, *supra* note 274, § 13 Rz.9.

^{ccc}_{ii} This is not a literal translation, but rather a paraphrased translation ... *aufgrund seiner Beteiligung am Kapital des Emittenten oder eines mit dem Emittenten verbundenen Unternehmens...*(sec. 13 p.1 No.2).

^{ccc}_{iii} BR-Drucks. 793/93; BT-Drucks. 12/6679, p. 46.

^{ccc}_{iv} Claussen, *supra* note 294, at 7.

^{ccc}_v *Id.*

^{ccc}_{vi} *aufgrund seines Berufs oder seiner Tätigkeit oder seiner Aufgabe bestimmungsgemäß...* (sec. 13 p.1 No.3).

^{ccc}_{vii} Kümpel, *supra* note 2, 14.162 uses the expression "*Tätigkeitsbezogene Primärinsider*".

^{ccc}_{viii} Hopt, *Das neue Insiderrecht*, *supra* note 281, at 10.

^{ccc}_{ix} Assmann, *supra* note 274, § 13 Rz. 18.

^{ccc}_x Hopt, *Das neue Insiderrecht* *supra* note 281, at 10.

^{ccc}_{xi} Ulf R. Siebel et al., *German Capital Market Law*, 45 (1995) use the expression "by destination".

^{ccc}_{xii} Assmann, *supra* note 274, § 13 Rz. 18.

^{ccc}_{xiii} Claussen, *supra* note 294, at 8.

^{ccc}_{xiv} Kümpel, *supra* note 2, 14.166.

^{ccc}_{xv} Assmann, *supra* note 274, § 14 Rz. 6. The German Civil distinguishes between the transaction constituting an obligation (*Verpflichtungsgeschäft*) and the disposition (*Verfügungsgeschäft*). Property is transferred by the disposition.

^{ccc}_{xvi} Assmann, *supra* note 274, § 14 Rz. 17.

^{ccc}_{xvii} Hopt, *Das neue Insiderrecht*, *supra* note 281, at 18.

^{ccc}_{xviii} Kümpel, *supra* note 2, at 14.173.

^{ccc}_{xix} James H. Freis, Jr., *An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland*, 19 B.C. Int'l & Comp. L. Rev. 1, 83 (1996). Sometimes, an outsider's look is simply not sufficient to understand the details of another system.

^{ccc}_{xx} Materials to the Second Financial Markets Promotion Act, BT-Drucks. 12/6679, p.47.

^{ccc}_{xxi} Hopt, *Das neue Insiderrecht*, *supra* note 281, at 12.

^{ccc}_{xxii} This is the translation of section 14 paragraph 2 in a paraphrased form. Section 14 paragraph 2 provides: *Einem Dritten, der Kenntnis von einer Insidertatsache hat, ist es verboten, unter Ausnutzung*

dieser Kenntnis Insiderpapiere für eigene oder fremde Rechnung oder für einen anderen zu erwerben oder zu veräußern.

^{ccccxiii} Section 27 of the German Criminal Code.

^{ccccxiv} In the recent insider trading case a primary insider was punished by a fine (*Geldstrafe*) in the amount of DM 3.6 million and an additional penalty (*Geldbuße*) in the amount of DM 1 million.

^{ccccxv} This is only a brief description of the outcome in O'Hagan. For further references *see*, Michael P. Kenny; Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10 (b)*, 59 Alb. L. Rev. 139 (1995); Beeson, *supra* note 4; Hall, *supra* note 191; Jay G. Mervin, *Misappropriation Theory Awaits a Clear Signal*, 51 Bus. Law. 803 (1996); Recent Case, *Securities Law--Insider Trading--Fourth Circuit Rejects Misappropriation Theory of Rule 10b-5 Fraud Liability*, 109 Harv. L. Rev. 536 (1995); Horman, *supra* note 262; Jonathan E.A. ten Oever, *Insider Trading and the Dual Role of Information United States v. O'Hagan*, 92 F.3d. 612 (8th Cir. 1996), 106 Yale L.J. 1325 (1996)

^{ccccxvi} In the following observations I am applying the German language style which is applied in resolving legal cases.