Insider Trading

Legal and Economic Analysis
of the Insider Problem
in
South Africa, England and Germany

- Towards a Code based on a democratic market protection approach -

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Dedication

I dedicate this book to my mother. Without her love and care I would not be who I am.

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Opinions expressed and conclusions arrived at are exclusively those of the author.

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Abbreviations

AG	Aktiengesellschaft
AktG	Aktiengesetz (the German Stock Corporations Act)
All ER	The All England Law Reports
BB	Betrieb-Berater
BCC	Brithish Company Law Cases
BCLC	Butterworths Company Law Cases
BFuP	Betriebswirtschaftliche Forschung und Praxis
BGH St	Bundesgerichtshof Entscheidungen in Strafsachen
BGHZ	Bundesgerichtshof Entscheidungen in Zivilsachen
BR-Drucks.	Bundesratsdrucksache
BT-Drucks.	Bundestagsdrucksache (containing also the official ground for the legislation)
Bus	Business
BverfGE	Entscheidungssammlung des Bundesverfassungsgericht
BZ	Börsenzeitung
CA	Companies Act
CAO	Company Announcement Office
CAP	Capital Asset Pricing
CILSA	The Comparative and International Law Journal of Southern Africa
CJA	Criminal Justice Act
CMLR	Common Market Law Review
Comp Lawy	The Company Lawyer
Cr App R	Criminal Appeal Reports
CSA	Company Securities Act 1985
DB	Der Betrieb
dt.	Deutsch
DTI	Department of Trade and Industry
ECR	European Court Review
EEC	European Economic Communities
ECtJ	European Court of Justice

EMCH	Efficient Capital Market Hypothesis
engl.	English
EPC	Eastern District Court Reports
EU	European Union
Eur	Zeitschrift Europarecht
EUT	Treaty on the European Union (Maastricht Treaty)
EuZW	Zeitschrift für Europäisches Wirtschaftsrecht
FAZ	Frankfurter Allgemeine Zeitung
HGB	Handelsgesetzbuch (German Commercial Law Code)
HC	House of Commons
HL	House of Lords
IDA	Insider Dealing Act (ie CSA 1985)
IHR	Insider-Handelsrichtlinien (engl.: guidelines on insider trading)
int	international
ISTA	Insider Trading Sanctions Act 1984
ISTFEA	Insider Trading Sanctions Enforcement Act 1988
JIBL	Journal of International Banking Law
JZ	Juristen-Zeitung
LIFFE	London International Financial Futures Exchange
NJW	Neue Juristische Wochenschrift
NStZ	Neue Zeitschrift für Strafrechtswissenschaft
OJLS	Oxford Journal of Legal Studies
OMLX	The London Securities and Derivatives Exchange
OPC	South African Law Report, Orange Free State Provincia Division
OTC	Over the Counter
RNS	Regulation News Service
RIW	Recht der Internationalen Wirtschaft
SALJ	South African Law Journal
SA Merc LJ	South African Mercantile Law Journal

SC	Juta´s Supreme Court Review
SEA	Stock Exchange Act 1934
SEC	Stock and Exchange Commission
SFA	Securities and Futures Authority
SIB	Securities and Investment Board
SROs	Self-Regulating Organisations
Stell LR	Stellenbosch Law Review
StGB	Strafgesetzbuch (German Penal Code)
SZW	Schweizerische Zeitschrift für Wirtschaftsrecht
TGS	Texas Gulf Sulphur
THRHR	Tydskif vir Hedendaagse Romeins-Hollandse Reg
TPD	Reports of the Transvaal Provincial Division
TSAR	Tydskrif vir die Suid-Afrikaanse Reg
WLR	Weekly Law Reports
WM	Wertpapiermitteilungen
WpHG	Wertpapierhandelsgesetz (German Securities Trading Act)
ZBB	Zeitschrift für Bankrecht und Bankwirtschaft
ZG	Zeitschrift für Gesetzgebung
ZGR	Zeitschrift für das gesamte Handels- und Gesellschaftsrecht
zfbf	Zeitschrift für betriebswirtschaftliche Forschung
ZKW	Zeitschrift für das gesamte Kreditwesen

The aim of this dissertation

The term 'insider trading' is understood, in a legal sense and as an economic phenomenon, to mean situations where a person buys or sells securities when he possesses important information which affects or is likely to affect the value of those securities. These transactions are set apart from normal dealings because the other parties involved do not possess this same information.

Insider trading need not be limited to exchange markets, but can occur in almost any form of bargaining where there is an unequal distribution of information between the parties involved. The dealing in securities can take place at arm's length, even in shares that are usually quoted on the stock market. There could also be dealings in commodities or land[1], all transactions in which one of the parties is in possession of non-public information[2], and therefore has an advantage over the other party concerned. Although these transactions may have certain phenomena in common with insider trading on stock exchanges, this dissertation will examine only the latter because of its economic background.

One of the differences between the different kinds of transactions is that, whereas in face-to-face dealings an investor is exposed to certain risk factors related to these transactions, in stock markets he is able to diversify

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1 See one of the most celebrated US - insider cases, SEC v Texas Gulf Sulphur Company, 258 F Supp 262 (SDNY 1966), aff'd in part, rev'd in part, 401 F 2d 833 (2d Cir 1968), cert. denied, 394 US 976 (1969), in which a company intended to buy land which promised to give access to a major ore deposit (coppper and zinc) at a comparatively modest price after a successful strike. That intention was partly undermined because of a sudden increase of the share price. This was due to insider trading, which gave away much of the information about the deal - also causing a rise in land prices.

For an interesting analysis (based on a new theoretical approach to insider dealing) of how to measure the damages the company suffered see Macey, 'From fairness to contract: The new direction of the rules against insider trading', (1986) Securities Law Review 177 at 211; also published in (1984) 13 Hofstra Law Review 9.

2 Barrie and Carpenter, 'Ethics and insider trading in local government - a case of the law and the profits?', (1994) 9 SA Public Law 74.

the unsystematic risk specific to a given company or industry away in a portfolio.

Also, unlike other kinds of dealings, the price achieved on stock exchange markets is the result of heterogenous expectations.[3] From this perspective the investor is 'protected' by the price established through market processes, not by his personal bargaining power or position,[4] which is the case in face-to-face dealings. The pricing mechanisms ensure that the share price reflects the available information. The investor does not rely on individual, but on mandatory disclosure, and the price serves as a signal[5] to indicate the existence of certain information.[6]

Moreover, most legislation[7] provides that a contract is neither void nor voidable for reasons of insider dealing. This gives further - this time legal - evidence that there is a notable difference between face-to-face dealing situations and anonymous trading on stock markets.[8] This distinction is valuable for the purposes of this dissertation.

At first sight, one would think that such information-based dealings in securities on public markets is unfair because it puts the co-contractants on

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3 Schneider, 'Wider Insiderhandelsverbot und die Informationseffizienz des Kapitalmarktes', DB 1993, 1429 at 1433.

4 Scott, 'Insider trading: Rule 10b-5, disclosure and corporate privacy', (1980) 9 Journal of Legal Studies 801 at 808. The role of the price in the uniformed trading mechanism resembles the role of consensus forecast in expert opinion polls. Such forecasts tend to demonstrate greater predictive accuracy whenever individual experts have roughly equal access to diverse information or technical skills. Hence the more equal the informational level the more accurate the price mechanism.

5 So-called 'price decoding', see above all Verrecchia, 'Consensus beliefs, information acquisition, and market information efficiency', (1980) 70 American Econonic Review 874 at 881 fn 12.

6 So-called 'price transparence', see Carney, 'Signalling and causation in insider trading', (1987) 36 Cath University Law Review 863 at 881.

7 See, for instance, s 63(2) CJA 1993 Part V in the English law on insider trading which provides that no contract shall be void or unenforceable by reason only of a contravention of s 52 (ie the section on 'insider dealing').

8 See for this view the article by Millner 'Fraudulent non-disclosure' (1957) 74 SALJ 177 at 183, who correctly distinguishes between face-to-face dealings and dealings which occur on exchange markets.

unequal terms and thus renders the transaction in some way or other fraudulent or, as far as the insider is concerned, unethical.[9] Therefore, the uninvolved observer would probably wish to void such a contract and grant those investors who dealt with insiders the right to sue them. These issues lead us directly into a discussion of the economic problems surrounding insider trading. It will be argued in this dissertation that the so-called 'fairness' argument is not actually convincing after all.

We will see, for instance, that a considerable number of economists[10] think that losses caused by insider trading prohibitions outweigh the losses caused by insiders, and therefore argue that insiders should be allowed to trade freely. It will be shown that this opinion can be based on more than one economic approach or school of thought.

Moreover, there are many views which maintain that non-insiders suffer no losses at all.[11] This argument has strong legal implications because without losses there is not really a juristic basis for prohibition. On the contrary, insider trading is said by some theories to influence positively the performance of capital markets, by helping the share price to reflect more information than is available through mandatory disclosure. This argument, however, would seem appropriate only where the dealing is effected on an anonymous market. This confirms that insider transactions on stock exchanges should not be placed under the regime of the law of contract (such as face-to-face dealings).[12] For this reason we will not investigate the

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9 This 'fairness argument' and its moral implications will be dealt with in Chapter 1 of Part I of this dissertation.

10 The modern controversy was stimulated by Manne, 'Insider Trading and the Stock Market', New York, 1966 (cited as 'Manne'), whose arguments in favour of insider trading are so significant that they still have to be taken into account in today's legal debate.

11 Outsiders want to pay only 97% of the price which they would normally be prepared to pay for the same stock. They 'discount' expected losses to insiders, see Schörner, 'Gesetzliches Insiderhandels-verbot: Eine ordnungspolitische Analyse', Wiesbaden, 1991 at 149.

12 See for contractual remedies the analysis by Hurter 'Die regsposisie van die koper van ongenoteerde aandele in geval van verborge gebreke en wanvoorstelling', (1988) 10 Modern Business Law at 134. The approach suggested by Hurter, ie die 'beskikbaarheid van die aedilisiese aksies by die koop van onliggaamlike sake', idem

problem of face-to-face (insider) dealings.

Part I will also provide a detailed overview of the different economic schools of thought, and their applications to insider dealing. At this stage the economics of insider trading will be discussed. The first aim of this investigation is to paint an economic background to any statutory provisions on insider trading, including those to be examined in Part Two.

The debate on whether it is useful to regulate insider dealing still continues after many years of research. The main argument of the proponents of insider dealing nowadays is that insider gains can be regarded as part of the compensation packages of managers who would in return accept a cut in salary. This idea is mainly based upon the economics of 'principal-agent' relationships (the manager with insider knowledge being the agent). This notion will be discussed in detail.[13] It will be argued here that there is no necessity to ban insider trading from our markets.

Nevertheless, for reasons such as 'investor protection' and the 'competitiveness' of the home capital market, most countries, including those examined in Part Two, have adopted statutes the intention of which is to ban insider trading by making it an illegal act. We will examine whether or not such simplified catch-words as 'market protection' or 'investor protection' are valuable concepts which would justifiably enable State authorities to imprison insiders. It will be argued that our present understanding of 'market or investor protection' needs to be modified because of this simplified understanding of the situation.

The theory which is developed in this dissertation will take into account that there is no convincing economic model for suitably addressing the insider dealing issue. In such a situation, where we cannot prove that either prohibition or free trading on inside information is socially beneficial, what needs to be considered is whether market participants should define their interests and the protection of their markets themselves - according to their own priorities.

We live in an open, democratic society in which people hold many rational and irrational beliefs. Because of this it will be argued that market

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at 140, should, however, be extended to quoted shares if they are traded in face-to-face dealings; see also Eskinazi, 'The protection afforded in South African law to a purchaser of listed securities on the JSE', (1989) 1 SA Merc LJ 145.

13 See Chapter 2 of Part I.

processes should be allowed to determine which legal solutions equal out the interests of the parties involved. The market participants should, therefore, be allowed to put forward their opinions. That would make it necessary to incorporate more ideas in a legal model than just that of 'prohibition'. We will see a proposal that a better-fitting model under the given social data is to allow *and* disapprove of insider trading simultaneously. This reflects true democratic values; as with all others, the stock market should also be a truly democratic institution for the good of all involved.

Part Two will discuss the legal problems of insider regulation. It is argued that most insider legislation does not have a firm basis in economic findings, but rather on vague notions of 'market protection' and/or 'fairness'. The insider trading laws of England, Germany and South Africa will also be examined in detail. This also suggest which legal solutions can be offered instead of the existing regulations.

As shall be seen, there are notable differences with regard to the definition of 'the insider', as well as with regard to the concept of what precisely constitutes 'inside information'. Certain sanctions (eg criminal ones) are imposed on insider dealers, and it is debated whether or not also to impose civil sanctions. The three laws differ considerably in this respect, which makes it necessary to examine whether such civil sanctions are at all appropriate.

Finally, the legal issues, above all, the key elements of insider trading provisions, are brought in line with the economic findings discussed in Part I. Any evaluation of the systems in the three countries must take into consideration their different economic and historic backgrounds, as well as their current and future problems. I hope that inspite the fact that I have been somewhat influenced by my own legal education, this will be corrected with the consideration of the different national solutions being seen from an international context.[14] It goes without saying that imitation, even between countries which have similar legal and financial institutions, should be avoided. Yet it is still possible to reach an advanced understanding of both one´s own country´s laws and those of foreign laws by placing them side by side for analysis.[15] That is certainly one of the aims of this, and any, comparative analysis.

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14 See Zweigert-Kötz 'Introduction to comparative law, vol 1 - The framework,

To gain acceptance of a law concerned with insider dealing by most, if not all, members of a society, we would expect legal reasoning to take into consideration the economic aspects of insider trading. However, we will see in the course of this examination that there is no substantial economic argument either for or against insider trading. Absence of an economic basis for this issue makes it all the more difficult to favour one or the other legal concept, let alone to mould more appropriate legal norms.

This apparent absence of an economic basis suggests an alternative legal solution, which is open to both banning and non-banning of insider trading simultaneously. The aim of this approach is to ensure that at all times the market participants, above all shareholders and firms, can define and protect their interests by themselves without outside interference. This, it is argued, deserves to be called 'market protection' in a truly democratic sense. It will be shown that most present insider trading legislation is based on the interests of financial market people, and not on the interests of firms and shareholders. As these last-mentioned play the main role in the allocative process, it is of vital importance to reinforce their interests.

To make this more apparent to the reader, I shall in the final chapter put forward some suggestions for a Model Code which addresses the regulatory problem of insider dealing without favouring one or the other of the examined laws. It will be argued that this Model Code needs to be based on both the legal and economic findings of the examination, and leaves it open to market participants to define their interests with regard to insider trading. Thus 'market protection' is achieved by means of a balance of all interests which may play a part in the insider trading issue.

Oxford, 1987 at 16.

15 See for the aims of comparative analysis Zweigert-Kötz op cit at 13 et seq.

Part 1: Economic data for a legal topic

The first part of this dissertation will focus its attention on the economic background of insider dealing regulations. The second will examine more closely the relevant legislation of England, Germany and South Africa. To evaluate existing statutes it is necessary to develop a theoretical background against which the pros and cons of the examined rules can be discussed.

The investigation will start with a closer examination of a very common argument used in the insider dealing discussion, namely the 'morality' or 'fairness' argument. Once we have discarded this apparently weaker argument, it will become obvious that we shall have to examine in depth the economic approaches to insider dealing. This examination of the economic data will encompass, in its first chapter, a presentation of different economic schools of thought such as *Ordoliberalismus* , transaction cost models, the Chicago School of Law, and market process oriented view.

In a second step, their theories will respectively be applied to insider dealing problems. The presentation of these theories will lead our interest to focus on market processes and their implications for insider regulation approaches (Chapter 2 of Part I).

Chapter 1: Legislative approaches to and three common arguments against insider dealing

Before we can examine the economics of insider dealing, we will have to consider some common arguments used in insider dealing regulation models - either to back up prohibition or to allow free trading. These are namely the 'laissez-faire' approach and the 'fairness' or 'morality' argument. This chapter will also provide, a general overview of different possible legal approaches.

A. How can the law address insider trading?

In the context of how insider trading can be addressed by the legislator, some further remarks are necessary with regard to the aims of this dissertation. It is pointless to present all the different solutions to insider trading of industrialised nations, because this would necessarily remain a shallow surface study. As soon as one goes into detail and analyses the different laws, one would lose sight of the main underlying principles involved.

The way of presenting legal issues favoured here, is to compare three existing laws on insider trading, taking into account the economic findings of Part I. This is done in Part II, the laws chosen being those of England, Germany, and South Africa. The examination encompasses an evaluation of their respective pros and cons. Since these three countries have different cultural and economic backgrounds we can be assume that their solutions shed sufficient light on possible legal solutions in general. It is, however, not intended to provide a detailed overview on *all* legislative attempts to control insider activities throughout the rest of the world.

We want to know how to regulate this issue in future with fresh insights. Over the past few years insider prohibitions have been changed over and over again, which is proof enough that these laws did not offer convincing solutions for addressing the insider dealing issue. It would be of little interest to present them all here. Besides, that has already been done elsewhere.[16] What such legislation has to offer is a realisation that the question remains unsolved. That is the task: an examination which puts forward a new solution. The reader may then draw his or her own conclusions with regard to their own legislation. Only where the historic development is essential to understand current legislation, will it be explained in that context.

There are four different models of regulation which are modified from one country to another. The first one comprises statute law banning insider trading and making it unlawful. Here, for instance, a possible modification could be whether or not to impose criminal sanctions and/or civil sanctions on the insider. The second basic model would refrain from all types of regulation, thus allowing insiders to trade freely. The third (regulatory) model would consist of (private) rules within organisations and units, which determine both prohibiton or not and the extent of this prohibition. Insiders would be bound contractually by the organisations and/or individual firms who join such organisations - for instance all private or semi-private bodies in the corporate banking business.

A fourth model could be based on the economic uncertainty of insider

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16 Eg Assmann/Wegen (eds), 'Insider trading in Western Europe', 1994.

dealing and will be developed later in this dissertation. At the end of this thesis the 'democratic' approach to market protection will be suggested in terms of statutes which take into consideration both economic and legal findings of the examination.

The first three models occur today in various forms and with their own modifications all over the world in countries with stock markets. The statute model is very common, for example in the United States, although there are also rules by the Stock Exchange Commission (SEC) or other semi-public bodies. Nevertheless, statutes predominate in their insider systems. The non-regulation model was in existence in most European countries before the adoption of the insider dealing Directive in 1989, and its transformation into the national laws of the Member States. The third basic model, including private rules as opposed to public statutes, used to be the German model until the end of 1994, when the transformation of the aforementioned European Directive was finally carried out.

I. Non-regulation and 'laissez-faire' - approach

Non-regulation of insider trading offers at first sight considerable advantages. It would seem to be one potential field of the 'less State' model. This can be based on the assumption that the economy of a country can only profit when there are less public rules, for such rules would seem to deter the investment of foreign capital. Also, it would seem very likely that capital would go abroad and seek places with less prohibitions. The modern non-regulation models in Europe were not (at least not expressly) based on a laissez-faire approach.

A famous example to be cited, however, is England in the 19th Century. Foreigners with money were allowed to trade freely and to invest without being subject to complex regulation. Thus, one could be tempted to think in a somewhat over-simplified way that, without prohibitions of any kind there will be an increase of prosperity for the country as a whole. Such an argument is not convincing.

First of all, one must bear in mind that we seek an internationally-acceptable solution and not a legislative attempt to control insider trading by only one country. The example of the European Communities teaches us that benefit for the people of more than one country is most where a reasonable amount of harmony is brought about by legislation in all Member States through the legislative attempts undertaken by Brussels. This harmonising helps to enlarge and intensify the Common Market where one can invest everywhere under the same legal conditions.

Even if all countries opted for non-regulation - based on the hypothesis that the laissez-faire approach is the most suitable - we would create a situation where all insiders could trade freely, but we would still not know whether or not such trading is beneficial or detrimental. In such a situation it could as well be that the efficient allocation of resources is limited everywhere. We are looking for a legal solution which serves the interests of market participants in a larger context.[17]

Secondly, the view that less rules for insiders would create a better atmosphere for investment appears to be shortsighted because of the modern phenomenon of 'separation of ownership and control'. Today it would seem that the vast majority of insiders are managers who deal with other people´s money, but do not invest themselves - at least not significant amounts in the companies they work for. If the firm-risk were more balanced between insiders and shareholders, companies may perform better.

The problem of separation of ownership and control would only be solved in an economic situation where the insider is at the same time the entrepreneur. Creating the best surroundings for insider-managers, however, would not coincide with the creation of a better investment climate. On the contrary, the investor in a modern capitalist society would then rather look for a market where his own interest is protected against the insiders. Therefore, the laissez-faire approach has to be rejected.

II. Regulation and the 'moral' or 'fairness' argument

Prohibiting insider trading, on the other hand, can be based on various assumptions. Firstly, it could be assumed that insider dealing is economically detrimental for allocative efficiency. This argument relates to what is called 'market protection' (see Chapter 2).

Other arguments have more directly and obviously played a role in the

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17 The European Directive on insider dealing, OJEC 18.11.89 No L 334/30, for instance, is explicitly based on the assumption that ' ... such co-ordinated rules also have the advantage of making it possible, through cooperation by the competent authorities, to combat transfontier insider dealing more effectively.' That is a telling formulation.

legal development of insider regulation, namely the moral and fairness arguments and assumptions. It has been said that insider trading is immoral and/or harmful to outsiders. Most people seem to assume losses incurred by non-insiders when dealing with insiders. We can classify this group of arguments as the 'protection of the individual' - approach. Legally, this approach becomes relevant when civil remedies are sought in order to protect market participants (we are not concerned here with punitive damages, because their function is not reparation or compensation so much as penalty).

The question whether non-insiders incur (juristically relevant) losses needs to be regarded in the economic context, more specifically when we examine market processes later on. There we will see that market participants have enough investment techniques to ensure that they do not suffer losses to insiders which would require legal response.

Consequently, at this early stage of the examination, we have to inquire into the question of whether insider trading is immoral. Curiously enough, this examination will also provide us with good arguments against the assumption that outsiders incur any legally relevant losses due to insider trading. We seem to be in need of an answer to the philosophical question: 'what is morality'? However, this is certainly not the place to develop a concept of morality[18], so, we must ask ourselves what can be *immoral* about insider trading. Most anti-insider provisions seem to have a rather strong moral support.[19] What are the underlying concepts? The main conceptual ideas are the 'misappropriation' analysis and the 'fiduciary' approach which will both be discussed. According to the fairness approach it is unfair to trade on the strenght of a disparity[20] of information. Some even say that fairness is achieved (only) when insiders and outsiders are in equal positions (hence 'equal access' - theory)[21].

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18 Nevertheless, none of the writers cited give an actual definition of what 'morality' is supposed to be. This is certainly a shortcoming because he who judges insider trading as unethical should also be able to define in positive terms what moral behaviour on capital markets look like. At least some writers try to explain what immorality consists of. Those amongst the moral-concept writers who are simply of the opinion that insider trading is immoral - without at least naming the criteria upon which they base their hypothesis - will not be dealt with because of their omission.

19 For the alleged moral implications of insider dealing see Rossouw, 'The morality of

Unequal information is, however, unavoidable in our world since, for instance, the manager will always know more than the shareholder. But unless there is something unethical about the division of labour, this is certainly not unfair.[22] It would, then, not be only insider trading that is unfair (and unethical), but all transactions in which there is a disparity of information. This claim is overly broad.[23]

As the writer has elaborated elsewhere[24], the insider who owes a disclosure duty to the market cannot escape from that duty through refraining from insider trading. The duty to inform (disclose) is laid down in the disclosure rules which also determine the extent of the 'equality' of information

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insider trading', (1991) 12(3) SA Journal of Philosophy at 66; Patterson, 'Insider trading and business ethics', New Zealand Law Journal 1984 at 369; for the 'fairness' approach see also Rider, 'Should insider trading be regulated? Some initial considerations', 95 SALJ 1978 at 79; see also Loss, 'The fiduciary concept as applied to trading by corporate 'insiders' in the United States', (1970) 33 Modern Law Review 34.

Very sceptical, McCarty, 'Business, ethics and law', (1988) 7 Journal of Bus Ethics at 881; Moore, 'What is really unethical about insider trading?', (1990) 9 Journal of Bus Ethics at 171, who takes the view that the breach of fiduciary duties is the constituent element of the insider´s immoral act, idem at 177. This is doubtful, because in most modern insider legislation the breach of a fiduciary duty is not considered relevant for the dealing offence.

20 Moore at 172; King Task Group, Draft Report on Insider Trading, 26 March 1997 at 5 - critical of the Report Stassen "Insider Trading Minority Report", 25 June 1997.

21 The main modern proponent being Levmore, 'Securities and secrets: Insider trading and the law of contract', 68 Virginia Law Review 1982 at 117 et seq., who defines the insider as someone owing fiduciary duties to the corporation and its current and potential shareholders, see ibid at 117 fn 2; a recent support of the equal access theory has been given by James Boyle, 'Shamans, software, and spleens', Harvard University Press, 1996 at 83, who argues that insider trading laws promote democratic values by ensuring relatively equal access to commercially valuable information affecting stock prices. Yet, Boyle does not explain why equal access is 'democratic', nor what exactly these democratic values are.

22 Easterbrook, 'Insider trading, secret agents, evidentiary privileges, and the production of information', 1981 Supreme Court Review 350.

23 Moore at 172.

24 Tippach 'Insider-Handelsverbot und die besonderen Rechtspflichten der Banken',

amongst traders on a Stock Exchange. Regardless of whether we consider these rules fair or unfair - an insider who respects these rules is not unfair because he respects the law.

It is generally understood in the law that there is no duty to disclose every single item of information before carrying out a business transaction eg buy or sell shares. Proponents of the morality approach accept[25] this hypothesis. Although the extent to which there is a duty to inform remains to be considered, it cannot be said to be unfair to act or trade on unequal information - unless there is something unethical about it in general... , which we shall now examine.

1. Morality approaches to insider dealing

Morality approaches offer three main arguments why insider trading could be immoral: misappropriation, harm, and fiduciary principles. The 'harm' argument[26] has to be placed in the context of economic loss ie the assumption that insiders cause such losses to individual shareholders. That will be considered later.

We could interpret the act of a corporate insider who deals on private information as 'theft'. Such an insider deprives the company of the sole use of the information, which is in itself an asset.[27] He misappropriates ('steals' to put it more bluntly)[28] valuable non-public information entrusted to him with the utmost confidence.[29] The 'misappropriation' theory was developed from this.[30] Theft is immoral, not only according to our penal codes, but also according to our moral beliefs. If the insider were a thief, we could assume that insider trading is immoral.

Secondly, one could argue that the real reason for prohibiting insider

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Köln, 1995, at 30 et seq.

25 Moore op cit at 172.

26 Moore op cit at 176, however, sees harm possibly caused by insiders as a moral implication. Conceptually, this seems perceivable. Yet for the purposes of this dissertation harm is a foremost juristic and economic issue which shall be dealt with in these respective contexts.

27 Moore op cit at 175.

28 Moore, ibid.

29 US v. Winans, 612 F. Supp. 827, citing Chief Justice Burger in US v. Chiarella.

30 For a more detailed analysis see Tippach op cit at 35-37.

dealing is that it erodes the fiduciary relationship that lies at the heart of our business organisations. Indeed, Moore[31] thinks that harm stems primarily from the cracks in the fiduciary relationship caused by permitting insider trading, rather than from actual trades with insiders. The fiduciary relationship is supposed to contribute to efficiency, since it encourages those who are willing to take risks to place their resources in the hands of those who have the expertise to maximise their usefulness.[32] The claim of fiduciary relationship is seen as not purely a 'private' matter. Its erosion would generate social costs as well as costs for corporations and shareholders.[33]

2. Yet it is not immoral - first aspects of a 'democratic' approach to insider dealing

It is important to keep in mind two ideas which render so-called moral argument highly debatable. Firstly, we have generally to be very careful when fairness or moral arguments are raised in legal discussion. In the law such arguments too often serve as discussion-stoppers, permitting advocates to assert conclusions without reasons while branding those who think otherwise as moral dwarfs.[34]

Secondly, even if we knew the contents of moral behaviour, we would still not know why we would have to do what ethics require, which in itself is also a philosophical question that remains unsolved.[35] This would at least have to be based on another hypothesis, namely that morality is a compelling as opposed to a freely-chosen behaviour. Yet we will not be able to solve these eternal human problems, and must limit our inquiry to the two abovementioned aspects: misappropriation and fiduciarity.

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31 Moore op cit at 180.

32 Ibid.

33 Ibid.

34 Easterbrook, 'Insider trading as an agency problem', in: Pratt/Zeckhauser (eds), 'Principals and agents: The structure of the business', Boston, 1985, 81 at 83.

35 McCarty op cit (ethics and law) at 889.

The theory of misappropriation may sound persuasive[36], but has, in fact, little value. In Germany, for instance, before the European anti-insider provisions were enacted, firms could under the old system of voluntary rules have charged their insiders for trading on corporate information.[37] Yet, they never did; a fact which may indicate that insider trading is not truly harmful to corporations.

Another reason for the above-mentioned failure of corporations to outlaw insider trading may be that they did not wish to waste scarce resources on continous and extensive monitoring.[38] But this is not very convincing: even if some say that there is no place for ethics in the (firm-) internal perspective,[39] and that since profit is all that business takes seriously, then business ethics are at least a device to make higher profits. For then, the top 50 big enterprises in a country like Germany would at least have adopted such internal 'ethical' rules to increase their profits. Or do we really think that institutions like the German Bank, Daimler Benz, Shering, or Bayer would be financially unable to develop ethical conduct rules if there were a chance of losing out if they did not?

It is important to note that these companies still adopted internal codes of conduct before the insider prohibition became law (and at the moment they are busy extending these rules). The writer suggests that a change of mind of a majority of shareholders, politicians, board managers, bankers, and corporations was required in order to implement a new thinking which argued that insider dealing can be detrimental for the market. And this, of course, is based on the 'democratic' assumption that, at the end of the day, people decide by themselves what they think is good for them and what not. They may be wrong, but they are free to decide. From this we can conclude that, before insider dealing was prohibited, the majority of people did not think it was actually harmful. This will play an important role in the development of a new legal approach to insider dealing.

The next shortcoming of the misappropriation theory is that it does not encompass market information. Such information is normally 'given' to the

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36 Cf Merwin, Jr., who favours this theoretical approach, 'Misappropriation theory awaits a clear signal', The Business Lawyer 1995/6 at 803.

37 On the basis of § 404 AktG.

38 Moore at 179.

39 For a discussion of this approach see McCarty op cit at 882 et seq.

public at large as opposed to corporate information, which is designed to serve the (private) interests of the company.

Another serious shortcoming of the misappropriation theory is that it is based on an incorrect hypothesis. The theory states that the information is 'stolen'.The notion of theft implies that the thief benefits from the value[40] of the stolen object. Corporate information, however, is not meant to be used on capital markets in order to carry out profitable stock transactions. Such information is generated, for instance, to launch a new product range. The profitable insider transaction does not, strictly speaking, represent the value of the information. The insider ('thief') exploits a mere side effect of that information without rendering the company unable to increase their profits on the basis of their new product. On the other hand, if the insider were to disclose the information before the share transaction, the company would almost certainly lose ground to competitors who could use the new information for free. Even if the alleged thief deals, the companies so not become less profitable.

On the other hand, one would certainly agree with Moore [41] that fiduciary duties owed by managers (and employees) to the firm and its shareholders has a long and venerable history in our society. Also, it seems right to assume that nearly all of our important activities require some sort of co-operation, trust, or reliance on others.

Yet at the basis of her reasoning there is a serious flaw. She argues that the increase in the circulation of 'false information' would cause a general decline in the reliability of information and a corresponding decrease in investor trust.[42] However, announcing false information or 'rumours' that the company has a new product[43] is not insider trading, but stock manipulation. Such manipulation constitutes a wrongful act, but does not constitute insider trading.

In a nutshell, the fiduciary concept refers to trust and uprightness in the business world. For stock markets this is too restricted, because it would

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40 Someone who steals a savings booklet in fact only steals the money on the account if he succeeds to draw the money. The booklet itself has little (if at all) value.

41 Op cit at 180.

42 Ibid at 180.

43 For this example see Moore at 179.

exclude from the insider-definition all persons who have no[44] fiduciary obligation to the company. The market insider or the 'tipee' (ie a person who receives information) could never be found guilty of insider trading on the basis of that concept.

Due to anonymous trading on stock markets, the outsider[45] never knows the identity of his trading partners. His reaction would be either naive (ie trustful) or distrustful towards all market participants on the other side of the market, eg as a potential buyer of shares towards all potential sellers. This investor would protect his interests (by discounting expected losses from the stock price)[46] against everybody who trades on non-public information, whether or not the other person is bound by fiduciary duties. Market performance is more likely to suffer from such a uniform hostile behaviour by outsiders than from insider dealing itself. The validity of the fiduciary concept is hence doubtful, because it does not reflect the realities on exchange markets.

Moreover, it is perfectly conceivable that some firms allow their managers to trade on inside information, because theoretically every firm can define the extent of the fiduciary duty which is required by a manager. The contents of fiduciary obligations could vary from firm to firm. Which kind of fiduciary obligation should then be enforced? This would never be know.

This counter-argument leads us to more a general discussion about this moral and fiduciary concepts. It has been assumed by the aforementioned authors that insider trading constitutes a violation of the fiduciary concept. But is there enough reason to believe this? The answer is no, and this is so, because such an assumption unfortunately contains a petitio principii. Nobody has proved so far that insider trading is harmful to anybody. It is reasonable to assume that the manager should carry out all lawful activities in order to foster the performance of his company. He should then refrain from insider dealing only when it is established that such dealing is detrimental to the firm. If insider trading is beneficial for the firm (or for

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44 And that is sometimes very tricky to define. For instance, the printer in the Chiarella-case could have been from an external printing-works company in which case he would owe fiduciary duties only to his own employer! For this argument see Tippach op cit at 34.

45 Yet, of course, market insiders are often able to detect the identity of insider traders.

46 See Schörner op cit at 149.

the market and thus indirectly for the firm), he could trade on his advance information. Without knowing what beneficial effects insider trading might have, we cannot assume that such trading is contrary to the fulfilment of fiduciary duties.

B. Summary

Non-regulation of insider dealing - in so far as it is maybe a possible model solution to insider trading - cannot be based on a laissez-faire approach.

Often, the harm allegedly caused by insiders is implicitly taken for granted. However, the first important finding was that, although insider restrictions seem to have a good deal of moral support, opponents of insider dealing could not prove that such dealing is in fact harmful in any respect. This leaves it open to further investigation whether insider dealing causes measurable harm. As far as the moral analysis goes, insider trading as such is not immoral. Trading on unequal information is neither contrary to the law nor to morality. Nor do the informational imbalances involved make it unfair, because typically all kinds of contracts in our modern world where division of labour prevails, are based on the fact that one co-contractant knows more than the other.

The concepts of misappropriation and fiduciary duty were analysed with regard to their moral implications. The conclusion reached was that the insider who trades does not misappropriate the information in the sense that he would steal the value of this object from the corporation. The misappropration theory is a misconception because it assumes that the company may allow the insider to trade, which would obviously be contrary to the worldwide existing insider trading prohibitions. These prohibitions are made by the State and can, at this stage of the development of insider trading rules, not be modified by private companies.

We have also seen that the insider does not violate the fiduciary principle. Fiduciary duties are always violated when insiders cause harm to the corporation or to the shareholders. Yet, as long as we have not proved that their trading is in fact detrimental or beneficial, the claim made by proponents of moral arguments against insider dealing implies a petitio principii. And therefore, on this merely hypothetical basis, insider trading cannot be said to be immoral.

Chapter 2: Economics and insider dealing

In Chapter I we have analysed the arguments for and against moral support of insider trading provisions. It was argued that the strong moral support of anti-insider provisions is not justified. Perhaps even more important, the findings draw the lawyer´s attention to the major importance of theoretical economic considerations in evaluating the internationally differing legal approaches. Having discarded moral arguments against insider dealing, it is now convenient to start the economic analysis of exchange market transactions based on non-public information.

A. The purpose of this Chapter

In this Chapter we will examine the different economic views on insider dealing and their respective arguments. Through this, our own theoretical basis is also further developed, for we shall see that there is no convincing economic model. In this context we shall discuss the alleged harm to investors caused by insider transactions. It will be argued that there are no such individual losses, a fact which undermines all legislative attempts to base insider prohibitions on the 'protection of the individual' approach.

En passant, one will also see that the whole concept of 'disclose or abstain' which was designed by US legislation to protect such individual interests, was in fact a misconception. Investors have certain techniques to protect themselves against the eventuality of insider-induced losses.

B. Interaction of law and economics in general

'Efficiency is my primary concern' -

This statement by Harold Demsetz[47] has become quite famous, and not only in economic literature. Its programmatic sense stands for a view which is also relevant to modern legal issues. Some think that any legal provision must be moulded in such a way as to ensure maximum efficiency when applied. The Chicago Law School scholars are among the most eminent writers of this economic analysis of the law. One could certainly argue that

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47 Demsetz, 'Perfect competition, regulation and the stock market', in: Manne (ed), 'Economic policy and regulation of corporate securities', Washington, 1969 at 16.

what they have done is to transform economic efficiency into a value.[48] It is beyond any doubt that their perspective has added considerably to the evaluation of legal rules. Criteria such as reduction of transaction or monitoring costs need to be considered when we examine the economic implications of insider dealing.

For the elaboration of insider dealing provisions it is important to note that much attention is given to economic aspects. However strongly the proponents of insider trading prohibition stress the insider's unfairness or his unethical behaviour towards other investors, it would be unwise from a modern perspective of juristic thought to condemn insider dealing if it were economically beneficial to the market - if both the individual investor and the insider would benefit from its positive effects, such as, for example, by more accurate pricing of the shares which might enhance allocative efficiency. The German stock market, for instance, seems to have been dominated by insiders and yet its performance during this period was good.

The efficiency argument raises some doubts as to whether criminal sanctions should be imposed on the insider - if his buying or selling of securities does not damage the market. On the contrary, if insider trading were beneficial, it would even seem highly unfair and immoral to put into jail those who enhance the market performance through their informed trading. Their transactions would align egotistic behaviour and public welfare. And do not the vast democratic majority in the market system favour this idea of the overall welfare through individual welfare? At least some of the goals would be achieved which proponents of insider trading predicted when the ban on insider dealing is lifted, namely the fuller reflection of information in stock prices (which fosters allocative efficiency), and further incentives to produce favourable information on the side of entrepreneurs[49], who would find themselves adequately rewarded

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48 See Kripke, 'Manne´s insider thesis and other failures of conservative economics', 4 Cato Journal (Winter) 1985, 945 at 948: 'Some loss of efficiency must be endured for the sake of a larger goal.'

49 Manne, 'In defence of insider trading', Harvard Bus Review 1966 (Nov/Dec) at 118. This argument, namely, the fact that in a modern corporation the person who creates relevant items of information would no longer be the one who owns the company, has certainly raised quite some criticism. It was also criticised that managers who trade on insider information would be at the top of a hierarchy in

for their socially important work. What needs to be examined is whether or not insider transactions are in fact harmful. In that case regulation would seem to be inevitable.

C. Is insider trading economically harmful?

Is insider dealing economically harmful? This is indeed the most important and disputed point in the whole discussion.[50] As we have seen, many writers simply assume that insider dealing must somehow be harmful to other investors. We shall see, however, that this contention is not well-founded.

I. Situations where harm is allegedly caused to outsiders

In this subsection we will discuss the notion of 'harm' in the insider trading context. Some of these examples are cited because at first sight they seemed to prove that insider dealing is harmful. But things are not as clear as they may at first seem, especially when one looks at the various hypotheses upon which the harm-assumption is based.

1. Harm and hypothesis

The basic idea behind the following examples is that the non-public information will bring about a change in stock prices when it becomes public. Simplified, the assumption is: good information will increase the share price, and vice versa, negative information brings it down (again,

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whose lower ranks the actual information is generated. As a result of the latter, the person creating the information would no longer have an incentive to generate such information. Cf for instance Schotland, 'Unsafe at any price: A reply to Manne, insider trading and the stock market', 53 Virg Law Review 1967 at 1425; cf also Kripke op cit at 945-957.

50 See the excellent article by Wang, 'Trading on material non-public information on impersonal markets: Who is harmed, and who can sue whom under SEC Rule 10b-5?', (1981) 54 Southern California Law Review 1217, who finally suggests that 'each act of insider trading does in fact harm other individuals', idem at 1234 et seq., but that the individuals cannot be identified; see also Herzel/Kratz, 'Insider trading: Who loses?', (1987) 165 Lloyds Bank Review 15 who suggest that insider dealing does not lack victims, but rather credible plaintiffs. The present author thinks, however, that it is exactly this fact which indicates that no-one is harmed at all.

here, subsequent to disclosure). The insider is then assumed to profit because he knows the 'true value' of the share and can either sell or buy before the price reacts.

In terms of capital market efficiency hypothesis ('EMCH') this hypothesis is not uncontested. Some economic authors think that all information, including the non-public(!), is at all times reflected in the share price. That is the so-called strong version of the EMCH[51]. We cannot discuss this issue here, but it gives an idea of the extent to which the 'harm' argument is based upon hypotheses which are seldom truly stated in the juristic literature. Also the assumption that information is reflected in share prices is not without difficulties. We must bear in mind that the price is a function of heterogenous expectations about an uncertain future. These expectations are certainly influenced by many things. For instance there are days on the stock exchange when the general mood is bad, and even otherwise very favourable news does not result in an increase of share prices. We will have to take that into consideration before we assume harm because it fits into our world picture. But moving beyond these general considerations we will examine those situations in which allegedly insider trading causes harm to individual investors. These examples reflect the beliefs of most, if not all, proponents of insider trading prohibitions. Let us now have a look at them.

2. Buying before release of good news

The first of these classical examples is the very basic situation where an investor sells his shares without a putting a limit to his order. He would, for instance, sell his 500 shares in the xy-company at any price achieved on the Frankfurt Stock Exchange on a given day. The insider buying 100 or 500 or 1000 shares in the same company knows that good earning ratios for the first half year performance are to be announced in a couple of days. Allegedly, the insider causes harm to the other investor from whom he buys the shares.

The second example is taken from Moore[52] and this is certainly a more refined one. The alleged harm caused by the insider in this example is more

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51 See Fama, 'Efficient capital markets: A review of theory and empirical work', (1970) 25 Journal of Finance 383 at 383.

52 Op cit at 176.

difficult to prove wrong, ie to refute. It is assumed that someone has placed an order to sell his shares in Megalith Co., currently trading at $50 at share, at $60 or above. An insider knows that Behemoth Inc. is going to announce a tender offer for Megalith shares in two days, and has begun to buy large amounts of stock in anticipation of the gains. Because of his market activity, Megalith stock rises to $65 a share and the order is triggered. If the insider had refrained from trading, the price would have risen steeply two days later, and the aforementioned investor would have been able to sell his shares for $80. Writers like Moore think that, because the insider traded, this investor failed to realise the gains that he otherwise would have made.

3. Selling before bad news becomes public

The other type of example does not offer anything new. It simply reverses the premise. The simple version of this is the following: the shareholder - or rather the potential shareholder - places an unlimited order with his bank or broker to buy a certain amount of shares in the z-company. The insider who sells shares in the z-company knows that the company will have to recall a series of cars from the market, because they are faulty. This will generate extra costs for the corporation and thus decrease the profit for the term. The fact is due to be announced to the public tomorrow.

The more refined version of that same example is a situation where an outsider investor places the order to sell with a limit of $34. Normally, the limit would have been reached and the shares would have been sold. But many insiders are selling these days, and it is assumed that their activities result in a sharp drop of the share price to $33 so that the order is not being carried out. On release of the relevant information the share price drops to $28 and the investor is very unhappy. He, and with him a good number of writers, think that this happens due to the insider´s fault, for without the insider he could have sold the worthless paper. Are they right or not? It will be argued that they are not.

II. Why these examples fail to prove economic harm

All these examples, although they may sound convincing, fail to prove that insiders cause economic harm to the investor.

1. Outsider profits from insider transactions

The following example[53] will show that there are also situations where ordinary investors can profit from insider trading. Suppose an outsider tells his broker to sell some of his shares, currently trading at $45, if the price drops to $40 or lower (a so-called 'stop loss'-order). An insider knows of an enormous class action suit[54] to be brought against the corporation in two days. He sells his shares, lowering through his transaction the price to $38 and triggering the other investor´s sale. When the suit is made public two days later, the share price plunges to $25. If the insider had abstained from trading, the investor would have lost far more than he did. It seems that this investor was protected by the insider.

This example is structurally in line with the abovementioned ones. As we shall see, the inherent structure is disputable if not completely erroneous. Yet, assuming for a moment that the structure is correct, one can see that outsiders will in some cases accumulate gains through insiders who trade. Those ordinary investors have at least windfall profits. Actually, all outsiders who act on the same side of the market as the insider profit. When the insider sells and thus brings the share price down a little before it drops sharply, all other sellers acting simultaneously with the insiders profit from their transactions, provided their sell-limits are reached.

Moreover, all investors who buy (while insiders are selling) pay less than they would have without the insiders bringing the price down. What they get, however, may be worth less than it seems to be because they do not have the complete information about the stock in question.[55] Yet as far as information is concerned it is important to note that all outsiders acting on the same side of the market as the insider would not be able to sell if the

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53 Taken from Moore op cit at 176.

54 It is disputable whether or not such information falls within the ambit of the legal term 'inside information', because it was not generated by the corporation. Yet this needs to be discussed in the context of the definition of the legal terms later on.

55 Cf Moore op cit at 177.

insider made the information public. Then, of course, they would lose. These outsiders lose anyway, if insider trading results in a price change because they can only sell their shares at a lower price. However, the same would be true for potential buyers, if the insider were to disclose positive company news. These buyers would have to pay far more for the same shares.

There are also practical problems involved. Assume that the insider sells 2.000 shares on a day when 47.522 shares are traded in 10.000 transactions at 125 different prices by 8.500 different people, some of them insiders, others not. It is doubtful whether one could find out when which insider sold to which potential buyer at which price. Particularly on a market like the Frankfurt Stock Exchange where many shares are traded on the basis of the 'uniform price'[56] (dt.: 'Einheitspreis', being the price at which most share transactions can be carried out; the official market-makers are legally bound to trade at that price; all other prices would result in less offer/demand and thus less transactions) it would be difficult to establish if an outsiders suffered a loss to an insider (the outsider´s shares might as well have gone to another outsider!), and if so, what amount of money he may have lost (maybe only 10 of his 50 shares went to an insider). It is practically impossible to determine who suffers losses from insider trading while others might profit.

On a larger scale, however, alleged 'losses' and gains for ordinary investors seem to equal out as a whole with insider trading. The insiders create situations where the overall result of their trading is zero. Harm is perhaps caused to some ordinary investors, whilst others might profit from it without even being aware of it. Economically, insider trading generates a certain redistribution of wealth amongst outsiders, but none of them is systematically outperformed, because they would all trade sometimes with the insiders and sometimes on the other side of the market.

It is not even certain whether insiders *do* systematically outperform the market at all. An early empirical study on the topic carried out by Wu[57] came up with the following result: there is no sufficient evidence to prove

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56 For the mathematical procedure to calculate this price see Schörner op cit at 49.

57 Wu, 'Corporate insider trading profits and the ability to forecast stock prices', in Wu/Zakon (eds), 'Elements of investment', University of Pennsylvania, 1965, 442 at 448.

that insiders in 50 companies as a group had outperformed the market. This is a telling argument. Some more recent studies did, however, come to the conclusion that insiders outperform the market by 5-10%.[58] There is not even a convincing economic model which would prove that insiders can sufficiently exploit their information.[59]

Yet the most important point here is that the individual harm which may be caused to some outsiders is equalled out by gains made by other outsiders. This zero sum game, however, does not say anything about pros and cons of insider trading. Insider trading could still be beneficial for the market on the whole. Even if the alleged loss to all outsiders equals the amount of insider profits, the question of whether insider trading should be abandoned would by no means be answered.[60] We shall see that some economic approaches, such as institutional microeconomics or (partial) pareto models, go beyond the perspective of the individual harm.

2. Structural faults in the above examples

There are several structural flaws in the above examples. As far as the basic examples are concerned, there is a mixing up of alleged insider-induced losses and informational duties of the insiders. The insider is not always in a position where he is allowed to disclose his information. For instance a bank official who knows about a tender offer to be launched in two days is certainly unable to disclose this information prior to that day.[61] Hence the bank official would have to abstain. Then the ordinary investor would simply buy the shares from someome else because it is common to all stock markets that the orders will be carried out as long as they are unlimited (which was assumed in the first category of examples). Such an investor would be 'harmed' anyway. What really 'harms' the outsider is, in fact, the

58 See Gilson and Kraakman, 'The mechanisms of market efficiency', (1984) 70 Virginia Law Review 549 at 556 fn 27; see Schörner op cit at 181.

59 Most interestingly, however, already Manne furnished possible reasons for this phenomenon, see subsection hereinafter 'The position of Manne, his critics, and (...)'.

60 Manne (Insider trading) at 103 et seq.

61 It is assumed here that the disclosure of the information through the company is in accordance with the statutory disclosure requirements.

timing of the disclosure. Harm is due to the legal rules about disclosure.[62]

In most cases the company insider would also not be allowed to disclose prior to the plans of his corporation. It is not correct to assume that the insider causes the harm. Profits and losses can only be made in the bigger framework of the informational system as it is established by the law. From a psychological point of view, one may add that the outsiders, without yet being legally entitled to the new information, would have traded anyway, irrespective of whether there is insider dealing or not.[63]

The second of the underlying assumptions of those examples is that the insider knows about the 'true value' of the shares.[64] This true value includes the information still hidden to the public. But is it really correct to assume that the ordinary investor could buy or sell at this alleged 'true value' of the stock at all? Only if he could sell or buy at this price, would he be harmed through insider dealing which supposedly changes the price. One should again argue in terms of the informational system: as long as the disclosure rules do not require the company to disclose, the price is correct (ie in the juristic sense of the word even though perhaps not in the economic sense) because it reflects all legally available information. The investor who sells or buys on this informational basis will always get the 'correct' price.[65]

This price would then be incorrect only if the insider changed it through his transactions. And that is indeed the third assumption implied in the above examples. The second and refined type of these examples assumes that price limits are reached through insider trading itself. This assumption, however, is incorrect.[66] First of all, none of the insiders has any interest in making everybody aware of their transactions. They trade a good deal in advance of the date of disclosure. Whenever one observes carefully the developement of share prices, one will see that there is only price fluctuation shortly before the announcement of new information. This seems to be due to the

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62 See Tippach op cit at 61 et seq.

63 King/Roell, 'Insider Trading', (1988) Economic Policy 163 at 168. This is in some ways also the basic assumption of Manne at 100-104, 109, who concluded that there is no link of causality between insider trading and alleged individual losses. His position will be discussed in a more detailed manner further on in the text.

64 See Schörner op cit at 46.

65 See Tippach op cit at 61et seq.

66 Schörner op cit at 49 et seq.

fact that secondary insiders like financial analysts trade high volumes once they get the information - and that happens only close to the announcement itself. Economic research suggests that insiders refrain from trading big volumes because that would make other investors aware of it.

Moreover, insiders do not have the market power to influence prices significantly.[67] Consequently, their trading volume is not big enough. And even if it really changes the price slightly, there are always professional investors who decode this as trading signals for new information. Such trading or volume signals play an important role when market processes are discussed further on. One function of these signals is that they hint at potentially interesting new information - thus creating incentives for professional investors to adjust the price in the 'correct' direction, ie the direction which the price will take once the announcement of the respective news is made. Other investors will also profit from this price adjustment, because the 'true value' of the share is reflected better by the price when insiders trade.

Another important point in the 'harm' discussion has not yet properly been made, and that is 'self responsibility'. If there is an event like the quarterly earning announcement, or the half-year performance, every investor can wait until the announcement is made before he trades. There is always a bit of luck involved if one buys or sells shares because the future is uncertain. One would never be able to precisely predict the result of such an investment. The ordinary investor (and also the insider) bears this risk of selling or buying too early. If the ordinary investor procedes to trade knowing that an announcement is due to be made, it is certainly his own 'fault'. In many cases he will also profit from such a risk because the information may as well be positive.

This informational risk can only be excluded if the investor waits until the announcement is finally made. Then, however, the possible profit is also gone, because prices adjust immediately. The insider tries to avoid this informational risk for himself, yet by doing so he does not cause harm. Moreover, outsiders have developed great skills to avoid possible harm through insider trading. (see further on in the context of market processes).

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67 Carlton/Fischel 'The regulation of insider trading', (1983) 35 Stanford Law Review 857 at 866, who have observed less dramatic price changes where insider trading occurs.

3. Findings so far

Apparently, we live in a strange world when it comes to the insider trading issue. Because we are accustomed to a way of linear thinking which makes us believe that where there is a gain there must be a loss, we get stuck in the 'harm' debate. In this subsection it was argued that this is not necessarily so. On capital markets it is in fact different. There are losses due to informational imbalances, and insiders may or may not gain from their advanced knowledge. Yet their trading does not cause losses. The outsider would not be better off, if he traded with another outsider. If there are losses through insider trading, then at the same time there are as many gains to other outsiders, because many transactions are carried out simultaneously, and they all contribute to the current price situation.

This unique feature of capital markets is opposed to face-to-face dealings in which the gain to one co-contractant is a reflection of the loss of the other. We have also seen that the 'disclose or abstain'-theory upon which most of the American insider dealing approach is based is not valid. Whenever the insider refrains from trading, investors do not profit. The 'harm' argument blurs the fact that investing on stock exchanges is a market process. Even with insider trading there may be gains and losses, but at the end of the day the situation balances itself out. The insider does not bring about any major price changes. If one looks upon insider dealing as an issue of protecting the individual, however, one gets stuck in a zero sum game situation without ever realising its possible benefits. It simply does not matter whether occasionally one or other investor suffers a loss. Even in the very unlikely case that an order limit is reached due to insider trading the main factor which causes individual losses is the informational situation for which the insider is not responsible.

Harm other than this relates to the organisation of disclosure requirements or self-responsibility, not, however, to insiders. If one were to keep up such one-sided arguments, it would indeed be pointless to regulate insider trading. In order to avoid this, we shall now enter into the economic analysis of insider trading.

D. Presentation of the main economic schools of thought and their application to insider dealing

At this stage it is necessary to have a more detailed look at the economics of insider dealing. It is of interest both for interpretation and of developement of the laws on insider dealing to discuss the economic arguments and theories around this topic, especially those fairly recent ones which focus on agency problems. It is also necessary to discuss the economics of insider dealing with respect to the enforcement problem, namely the sanctions to be imposed on insiders. It is doubtful whether we should put an insider into jail if we is not sure about the effect of his transactions.

Another interrelation between the adequacy of sanctions and insider contraventions is evident[68]: normally, if the legislation increases fines, one would expect a greater deterrent to have been created. There are, however, some reasonable doubts. What we can say about most insider sanctions (worldwide) is that they have proved to be far less efficient than they were intended to be.[69] And, as a matter of fact, the transactions of an insider on stock exchange markets are economic ones, whose legal implications cannot and should not be discussed without a thorough basis of economic knowledge. For this purpose we shall now consider in some detail the main economic theories and their respective application to insider trading.

Before one can embark on an evaluation of the statutes, one will certainly have to define one´s own position with regard to the economic findings. This will be undertaken in the next subsection. The lawyer will find that not only is much debated in his own field, but also in the area of economic research. Due to the variety of opinions among economic writers, one needs

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68 See Botha, 'The economics of the crime and punishment of insider trading in South Africa', (1992) 4 SA Merc LJ at 145; see in particular Becker´s seminal article 'Crime and punishment: An economic approach', (1968) 76 Journal of Political Economy at 169.

69 For the minor deterrent effect produced by increased sanctions in the US (they have more sanctions than anywhere else in the world) see Seyhun. 'The effectiveness of the insider-trading sanctions', (1992) 35 Journal of Law and Economics at 149; see Naylor, 'The use of criminal sanctions by UK and US authorities for insider trading: How can the two systems learn from each other (II)', 11 Comp Lawy 1990, (I) 53, (II) 83, who asks 'why are the results so poor?', ibid at 88.

to make sure that the economic basis of our evaluation is clearcut.

At the same time it must be understood that the discussion of economic theory herein is limited in two ways: firstly, due to the restraints of space, it is possible to present only the most important economic theories. Secondly, as mentioned above, the findings of economic research are disputed, and it must be clarified that the arguments are not generally accepted amongst economists. The present writer shares the view that criteria for the desirability of statutes and their further development are to be found in sources external to the law.[70] Economic findings contribute, however, to the exactness of the legal reasoning no matter to which extent they can be proved right or wrong.

We need to distinguish three major groups of economic theories, ie the liberal approach, the model of allocative efficiency, and, finally, a group of theories at the center of which there are market- and competition-processes as such. The first to be analysed here is the concept of freedom.

I. The concept of freedom as a framework to the economic analysis of legal rules

Everybody would certainly agree on principle that it is beneficial to grant the maximum freedom to both market participant insiders and non-insiders. How can that be achieved? Many economists discuss the concept of institutions. Institutions are looked upon as a set of rules which serve to facilitate future actions through rendering them more secure and making the results more predictable.[71] They can be subdivided into micro-institutional and macro-institutional views. It is one of the main concerns of economic research to determine an ideal framework of order, and which set of rules is needed to guarantee the maximum amount of liberty to the individual.

This classical liberal approach is mainly based on the seminal works of F.

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70 See Hayek, 'Recht, Gesetzgebung und Freiheit', vol 1, Regeln und Ordnung, München, 1980 at 98.

71 See Meyer, 'Entwicklung und Bedeutung des Property Rights-Ansatzes in der Nationalökonomie', in Schüller (ed), 'Property Rights und ökonomische Theorie', München, 1983 at 1.

A. von Hayek and Walter Eucken.[72] Its adaptation to modern theory, the so-called neoclassical concept of competitive (economic) freedom (the German term here describes it more correctly as 'Wettbewerbsfreiheit'), starts with the premise that competition allows each individual to employ his means and abilities for his own self-determined goals.[73] This concept comprises three basic assumptions: individual freedom will secure economic efficiency[74] ('non-dilemma' thesis); economic policy's only function is to ensure that the law should formulate some per-se restrictions ('rule of law' thesis)[75]; finally, that the market system is inseparable ('non-separabilis' thesis) in the sense that no single market must be regarded in isolation for analytical purposes[76].

1. Relevance for insider regulations

Each of those assumptions appears to be relatively problematic in regard to insider dealing regulations. Starting with the third assumption, regarding markets as a holistic systems does not seem very accurate. Apart from the general economic criticism against this thesis, it would seem impossible to define the relevant market for insider dealing. Is it the whole capital market as an organised and structured system? Or does it also comprise the private sale of shares (eg over the counter sales, or sales at arms' length in general)? Even if we consider only the capital market which is open to the public, this is a reasonably large market which allows a discussion of the freedom aspect. Thus the stock exchange is a *non-separabilis* market and the above concept is applicable.

Even more relevant with respect to insider dealing is the 'rule of law

72 See Hayek, 'Liberalismus', Tübingen, 1979 at 21-24; cf also Woll, 'Freiheit und Ordnung: die gesellschaftspolitische Leitidee im Denken von W. Eucken und F. A. von Hayek', ORDO, vol 40 (1989), 87 at 89.

73 See Hoppmann, 'Wettbewerb als Norm der Wettbewerbspolitik', ORDO vol 18 (1967) 77 at 79.

74 Hoppmann op cit at 80-82.

75 Hoppmann, 'Wirtschaftsordnung' at 112.

76 Hoppmann, 'Marktmacht und Wettbewerb', Tübingen, 1977 at 9. The latter assumption has been criticised, for instance by Schmidtchen, 'Fehlurteile über das Konzept der Wettbewerbsfreiheit', ORDO vol 39 (1988) 111 at 113.

thesis'.[77] Yet it must be kept in mind that restrictions placed upon insider dealing can comprise both types of regulations (ie prohibition not to do or command to do). Certainly, there are prohibitions with regard to dealing on inside information but we will also encounter a number of commands. First of all there are the various disclosure requirements which contribute to the current insider dealing system.[78] It would seem to some that the main purpose of insider dealing prohibition is to encourage timely disclosure.[79] Yet, it is also possible to define the injunction to disclose as a rule prohibiting insider dealing: 'it it forbidden to deal without previous disclosure'. This thesis has rightly been criticised.[80] The lawyer would also think that each prohibition, of course, contains the command to behave in a certain prescribed way.

The basic assumption is that granting freedom will enhance economic efficiency. The 'non-dilemma thesis' explicitly discards an efficiency approach.[81] It is assumed that efficiency will come, even if only as a 'side effect', once freedom is established. One can, however, argue against this assumption that efficiency, at the end of the day, could grant more freedom because it enhances public welfare on the whole. And indeed, as we shall see later, the welfare economics approach has turned the argument upside down: for the proponents of that approach freedom comes as a side effect when market efficiency is guaranteed.

Generally speaking, it seems to be difficult either to discard or approve of insider dealing prohibitions in terms of the freedom concept. Analysing the 'non-dilemma thesis' in a more detailed manner it must be emphasised that without a preliminary definition of what *freedom* and efficiency are, one will not be very successful, simply because one would have no paradigms against which the effect of insider dealing prohibitions could be evaluated. This question, however, remains unsolved.

Certain criteria are needed to define which restrictions are undue and which are beneficial. The problem is to clarify how much freedom is necessary

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77 Schörner at 76 assumes that this is the most important thesis for insider dealing.

78 Schörner, idem at 76.

79 Remember the American approach 'disclose before you deal'.

80 Schörner op cit at 77.

81 See Herdzina, 'Möglichkeiten und Grenzen einer wirtschaftstheoretischen Fundierung der Wettbwerbspolitik', Tübingen, 1988 at 25-28.

and for whom[82] - it could also be the insider who needs more freedom in order to achieve better results for the economy. At this stage economists have to admit that not a single practically applicable criterion has been developed. Therefore, the (neo-) classical approach cannot be applied as such to our problem. We have learnt, however, that freedom is also a value in economic theory. Since the freedom concept is not applicable, a new approach had to be developed in economic theory.

2. The new approach to competitive freedom

Consequently, it has been attempted to determine factors which indicate restrictions placed on competitive freedom. One indicator was said to be the number of buying alternatives for the potential buyer.[83] The application of this criterion to insider dealing is problematic because it has been developed for goods markets, not for share markets. Schörner[84] thinks that once applied to stock markets this criterion would rather constitute an argument against insider dealing prohibitions because the insiders (buying and selling) would be deterred and hence the number of buying alternatives would be reduced. This, however, does not seem to be so evident. It is equally conceivable that market liquidity is lowered through insiders, simply because other market participants are deterred by their mere presence in the market. The most that we can say is that in terms of competitive freedom it remains uncertain whether insider dealing prohibition is desirable or not. This is an important finding: in terms of economic theory it is not necessary to prohibit insider activities.

Another modification of the neoclassical concept has been suggested by Schmidtchen[85], who asserts that competitive market freedom must be interpreted as the freedom to do everything that is not regulated either through prohibitions or commands. Freedom develops in the context of this *protected perimeter* as the possibility to carry out all actions which are allowed. Competitive freedom can be defined only in terms of an historically grown juristic order.[86] The critical moment comes when one

82 Schörner at 77.

83 Hoppmann (Wettbewerb) at 87-91.

84 Op cit at 78.

85 Op cit (Fehlurteile) at 118 et seq.

86 Schmidtchen at 115, 119.

faces legal alternatives: if truly competitive freedom is defined within the boundaries of legal rules, the argument is circular because one would have to conceive a legal rule offering the greatest possible freedom which is, however, itself defined as part of the legal rules which define the limits of freedom.

Schmidtchen presents two alternative solutions in order to avoid this circle. One of them being an efficiency test, the other being an analysis according to 'the rules of just behaviour' ('Regeln gerechten Verhaltens').[87] The latter alternative tells us nothing useful because if we knew what justice is, we would not really be troubled - not even with regard to insider dealing. As to the introduction of the efficiency parameter, it is convenient to deal with this in more detail further below when the Chicago Law School is presented. To sum up, the freedom approach does not really offer an answer to the question whether or not to allow insider dealing. One can sense already that there is always another way of looking upon it, in both legal and economic reasoning.

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87 Schmidtchen at 120.

II. Efficiency-oriented policies

The second very interesting group of theories focuses our attention on efficiency patterns. The underlying general principle is that everybody will benefit from efficient (stock) markets. These writers argue that one will have more freedom the more efficiently the market functions.

1. The basic postulates of welfare economics and the pareto principle

It is the most important aim of any welfare economics approach to determine the welfare increase or decrease of a suggested or given political or legal measure through an economic analysis of such a measure. The two basic postulates of this concept are individualism and the sovereignty of the citizen. The first postulate is called 'methodological individualism' because it assumes that common welfare is based on the welfare of the individuals in a society. The second is meant to ensure that each individual can judge for himself whether a political or legal measure is beneficial to him or not.[88]

Economists have tried to determine a social welfare function (so-called 'collective choice' function), in other words: what general behaviour is needed to increase public welfare?. Yet, analysing an insider dealing prohibition on the basis of such a collective function is sure to fail.[89] The conceptual reason for this failure is that there is no possibility of establishing a non-contradictory social welfare function. We owe this insight to the findings of Arrow[90] who established the so-called 'impossibility theorem' in 1951 already. All later studies did not succeed in proving this finding wrong. It was said that one general conclusion is the durability and robustness of Arrow´s impossibility result.[91] This impossiblity theorem shall not be put into question. In other words there is no generally applicable parameter with which one could measure the

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88 Külp 'Wohlfahrsökonomik I. Die Wohlfahrtskriterien', 2nd ed, Düsseldorf, 1982 at 469 et seq.

89 Schörner op cit at 89.

90 Arrow, 'Social choice and individual values', 2nd ed, New York, 1963 at 24-31, 48-60, and 96-100.

91 Sen, 'The impossibility of a paretian liberal', (1970) 78 Journal of Political Economy at 152-157.

desirability of a certain socially relevant behaviour; and this can then, subsequently, be enforced by the law.

Since a consistent social welfare function does not exist, welfare economist refer to pareto principles as parameters to distinguish the good measure from the socially detrimental one. The basic pareto principle runs: a policy measure is only beneficial if no individual believes that his or her situation is deteriorated, and at the same time at least one individual thinks that his situation is improved through the measure.[92] Pareto optimum is achieved if no individual pareto improvement is possible without deteriorationg the situation of another individual.[93]

2. Evaluating insider prohibitions on the basis of welfare economics, pareto optimal, and partial pareto models

In terms of the welfare economics approaches we would have to ask ourselves whether or not restrictions on insider dealers would lead to a pareto optimum situation or at least to a pareto improvement. This is the classical restrictive pareto principle.[94] In order to determine the welfare increase we need parameters which reflect the welfare economic approach. Hence, we must have a closer look at the theorems and models of welfare economics.

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92 Külp op cit at 475.

93 Lockwood, 'Pareto efficiency', in 'The New Palgrave', ed by J. Eatwell et al, vol 3, London, 1987 at 811-813.

94 One argument against this restrictive approach is that it would be impossible to draw precise policy conclusions in case one single individual's situation deteriorates. Writers like Kaldor and Hicks put forward the idea of compensation: a policy measure is beneficial (although detrimental to some individuals), if the increase of welfare of the other individuals compensates individual losses, thus leading to an overall improved situation, see Külp op cit at 478. Kaldor and Hicks suggest that a mere theoretical possibility of compensation suffices - without the need for a real compensation to be carried out in practice. However, without such a duty to compensate the approach would lead to an undesirable redistribution of wealth. The compensation argument is inconsistent because it produces value judgements by people other than the individuals concerned (namely the people who determine the amount of redistribution). This, however, is contrary to the original pareto approach. For further details see Schörner op cit at 90.

a) The main theorems of welfare economics and their significance for the evaluation of insider restrictions

In order to measure a possible pareto improvement or pareto optimal, it is agreed that an equilibrium model of competion under the assumption of uncertainty is helpful.[95] The theorem derived from this asserts that a competitve economy achieves a pareto optimum, where all producers and consumers act as if they were being offered prices on complete[96] markets with full competition.[97]

The second main theorem says that various pareto optima can be achieved each on the basis of various initial distributions of (property) rights. Hence every competitive equilibrium can lead to an optimum situation in terms of pareto analysis which also implies that at least (initial) redistribution does not impair pareto optimality.[98] Only in this latter case there can be a distinction between distributional justice and allocative efficiency. However, where the market differs significantly from the competitve model, or if the assumptions of the two optimality theorems are not fulfilled, the above-mentioned distinction can no longer be made.[99] As long as the conditions required for this distinction to be made are not fulfilled, one will have to bear in mind that any change of the law, for example the restriction on insiders, can bring about (undesired) redistribution of (property) rights and thus be detrimental to the proper allocation of capital resources.[100]

We can learn from this that it is not so easy to justify economically restrictions placed on insider trading. This confirms the difficulties encountered in the context of the freedom approach. The important implications for insider dealing legislation is that, if one is not sure about the economic result of insider trading, it is certainly wise to apply

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95 See Arrow/Debreu, 'Existence of an equilibrium for a competitive economy', 22 (1954) Econometrica at 265-290.

96 This is a market in which there are prices, or more generally terms of exchange, given for every pair of goods, see Hahn, 'Reflections on the invisible hand', in Hahn, 'Equilibrium and Macroeconomics', Oxford, 1984, 111 at 112 et seq.

97 Hahn, 'General equilibrium theory', in Hahn op cit 72 at 74.

98 Hahn (General Equilibrium) at 74.

99 Arrow, 'Uncertainty and the welfare economics of medical care', 53 (1963) The American Economic Review 941 at 943.

100 Schörner op cit at 92.

prohibition with utmost care.

b) Problems arising from an evaluation based on equilibrium models and external efffects

Evaluating the pros and cons of insider dealing restrictions on the basis of such an equilibrium model poses several problems. The first being that the two theorems imply the mutual independence of buyers and sellers.[101] Individual actions or preferences (for example personal interdependencies), can result in effects *external* to the market which are detrimental. The market is unable to incorporate these external effects into its own mechanism, because they are unpredictable. The existence of such external effects is, therefore, equated with market failures - which eventually lead to the demand for public measures (eg taxes or other restrictions).[102] Consequently, in an equilibrium system it would seem necessary to impose restrictions on insiders because their stock operations are contrary to the general equilibrium. They have an informational advantage which might upset the pre-existing equilibrium.

But things are never quite the way they seem. If the informational imbalance (in favour of the insider) is assumed to be a deviation from the pareto optimum, it becomes obvious that the market failure approach implies a market which is free of any informational imbalances[103], namely a market without information problems at all.[104] This, however, calls for an opposing view. If the parameter for public reaction to alleged market failures were a world without any informational problems at all, then one would be able to justify all kinds of public intervention.

Yet there is no such economic system that meets the requirement that every piece of information is available to everybody and that everybody, therefore, has the same expectations about future events. This would mean that homogenous expectations of all market participants prevail. Demsetz[105]

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101 Schörner at 92.

102 Dahlmann, 'The problem of externality', 22 (1979) The Journal of Law and Economics 141 at 153 et seq., and 161 et seq.

103 Greenwald/Stiglitz, 'Externalities in economies with imperfect information and incomplete markets', 101 (1986) The Quarterly Journal of Economics at 229 et seq.

104 Schörner op cit at 93 draws this conclusion with which I agree.

105 'Information and efficiency: Another viewpoint', 12 (1969) The Journal of Law and

rightly calls this a 'nirvana approach'.[106] Our world is simply less perfect, if at all. Without a shadow of doubt, it would be useless to argue that an equal standard of information is achievable. Moreover, even if it were, it remains uncertain whether such equilibrium conditions are desirable.[107] Moreover, we do not know whether insider dealing prohibitions actually enhance the desired equilibrium at all. It could just as well be true that insider trading can help incorporate full information into share prices[108] and thus result in an informational equilibrium.

It is very difficult to operate with homogenous expectations as a given normative element for policy suggestions. Even if the norm were fulfilled, namely an informational balance were achieved, and insider dealing did not occur, it would still remain questionable on which level those expectations should be equal: on the level of the insider (ie full disclusure is required); or on that of the outsider (which would mean complete deterrence of insiders) or somewhere in between. Besides, it is extremely difficult to determine how such a homogenous level could be achieved.[109]

At the end of the day one will find that it is not really possible to determine how useful insider restrictions are as long as we use models which reflect a world in which insider dealing is absent. A further step becomes necessary: one has to choose a model analysis where the model is reduced to a more modest format (a partial pareto models). Such a model encompasses fewer people, but can still take into account the existence of asymmetric[110] informational levels. One such model is the principal-agent-theory applied

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Economics 1 at 19 et seq.

106 For an intensive criticism of similar proceedings in order to justify public interventions on markets see Eikhof, 'Theorien des Markt- und Wettbewerbsversagens', 66 (1986) Wirtschaftsdienst 468 et seq.

107 Eikhof, 'Soziale Marktwirtschaft' at 140, for example, thinks that such equilibrium conditions are a desirable goal.

108 This argument will be dealt with in the context of market efficiency.

109 See Schörner op cit at 94 et seq.

110 Asymmetric information is still one of the major problems in economic theory. In 1996, for instance, James A. Mirrlees and William Vickrey received the Nobel Prize for economic science for their work on 'incentives in asymmetric information situations', see FAZ 9.10.1996 at 19 et seq. They say that such informational imbalances have effects on both the individual risk aversion and the mechanism of markets.

to insider trading. Before we can examine it, some preliminary remarks about partial models in general are necessary.

c) Partial models, the 'second best problematic', and the theory of the third-best

Today it is generally accepted in economic literature that, as long as the pareto optimum cannot be achieved in all parts of a national economy, one has to face the so-called 'problematic of the second best'.[111] It is important to note that in such a situation the realisation of the other pareto conditions will not in every case result in an increase of welfare.[112] As far as policy issues are concerned, most theories assume that, at least partially, the optimum conditions are not fulfilled.

The problem is that, whenever one tries to adapt one part of the economy to the optimum conditions, ie the 'first best' solution, the result is that social welfare as a whole will decrease.[113] Then at least one of the optimum conditions is not fulfilled and the resulting restriction cannot be removed. This problem is summed up as the general theorem of the second best.[114] In terms of insider trading this means that even if the law prohibits such trading, other parts of the economiy can be affected in a negative way. Three possible solutions have been conceived to cope with this difficult yet inevitable situation: the first being simply to refrain from statements about welfare economics. This has to be discarded, because it does not contribute to an evaluation of the insider dealing problem.

The second solution would be to consider the restrictions due to the second best situation, yet try and mould a model with the aim of optimsing and deriving policy recommendations from it.[115] It is important to realise the difference between this constructivist second best analysis, and other models which try to examine the conditions of first and second best solutions. One of these models is the 'moral hazard' model, which relies on the

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111 See Lipsey/Lancaster, 'The general theory of second best', 24 (1956/7) the Review of Economic Studies 11-32.

112 Lipseq/Lancaster at at 11 et seq.

113 Lipsey/Lancaster ibid.

114 Külp/Knappe,' Wohlfahrsökonomik I. Die Wohlfahrskriterien', 2nd ed, Düsseldorf, 1984 at 44.

115 Schörner op cit at 97.

organisational skills and powers of co-contractant parties. This will be discussed in the context of the agency relations.

The big, yet unsolved, problem of the second solution is that its policy recommendations are far from being precise.[116] This inaccuracy must be inherent in any attempt to create partial models because we would have to regard every detail for every single person and good. Such a model could not even cope with informational problems. If, for instance, one wishes to impose import taxes in a (normal) situation where at least some taxes are politically unenforceable (ie a restriction to the model), all other (eg export) taxes have to be adapted because they are part of the whole tax system; and they would also have to be adapted in a second best way, and so on - an impossible task, if one considers that this calculation would have to be carried out for every individual consumer.[117]

As a consequence of this obvious impracticability inherent in the constructivist view, economists developed another approach which simply ignores the effects of the restrictions (or changes) in other areas. It was thus named the third best theory.[118] This approach is adequate because the informational and administrative costs of the second best approach[119] are taken into account; and because partial problems can be dealt with in conjunction with pareto patterns where sufficient separation of the different parts of the economy is granted[120], even though the *non-separabilis* requirement is not fulfilled. The stock market would seem to be a sufficiently 'separated' section.

Such a policy is less interested in intervention, and tries to cope with the individual weaknesses of the economic order on a step-by-step basis. This is far more practical. A further advantage of this model is that it has direct implications for insider regulation: regulation will affect the market process; as long as one has no complete model which is able to measure the (positive or negative) effects of insider trading regulation, one must

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116 Schlieper, 'Pareto-Optima, externe Effekte und die Theorie des Zweitbesten', Köln, 1969 at 81.

117 See Sohmen, 'Allokationstheorie und Wirtschaftspolitik', Tübingen, 1976 at 435; see for a very concise overview Schörner op cit at 98 et seq.

118 See Ng, 'Towards a theory of the third best', 32 (1977) Public Finance at 1-15.

119 Ng op cit at 1.

120 Schörner op cit at 99.

develop an interim (step-by-step) model; policy recommendations in either direction (put forward, for instance, by financial analysts) must be rejected, because they separate the market section.

The problem of this approach[121] is to determine how the (partial) pareto principle can be interpreted in terms of insider dealing. This problem must be disussed together with informational processes on markets as institutions in the subsection on 'institutional economics'.

d) Summary and interim conclusion

So far we have seen two types of model-exogenous concepts: the freedom approach and the welfare approach. From neither could we derive specific answers to our overall problem, namely whether insider dealing should be regulated or not. Nevertheless, this contributes a great deal to our question because it tells us that a certain suspicion is imperative wherever lawyers or economists suggests that regulation of insider dealing is the only possible answer. Since neither pure *freedom* nor pure *welfare* thinking are able to solve the problem, it is logically impossible for any other analysis which refers to freedom or welfare and requires regulation to be consistent. We must therefore be careful when people such as financial analysts claim that the gate to freedom on stock markets is banning insider trading.

From the various pareto economic approaches we have also learnt that it is extremely difficult to find parameters which enable us to measure the effects of both insider trading and regulation. We have seen that (non-) regulation has effects upon the markets. The overall implication for the insider debate is, however, that one cannot be sure whether or not prohibition is beneficial. This was confirmed both by the individual freedom approach and the welfare approach (ie collective protection).

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121 For a sustainable, argumentative and philosophical foundation see Popper, 'The open society and its enemies' vol 1, 5th ed, London, 1966 at 157-168; Schörner op cit at 100 calls this 'Stückwerkstechnologie'. This expression should not be misinterpreted as 'bungled' work, but simply be understood as a step-by-step approach.

III. Institutional micro-economics

The problem which remains unresolved by equilibrium models of any kind, was that these would result in an institutional vacuum. The legal framework plus all problems related to organizational questions were considered only implicitly as constant data.[122] This criticism of the various model approaches led to an analysis in the centre of which economists placed 'realisable' institutions (eg the stock exchange). From this angle it became possible to take into account individual business restrictions (eg trading prohibitions) and heterogeneous expectations of the parties involved.

There are three specific approaches which need to be presented as they have contributed numerous sustainable arguments to the insider discussion: the property rights approach, the principal-agent analysis and the economic analysis of law in the sense of the Chicago School of Law. It is worth mentioning that another approach which is based on the key term 'transaction costs' is methodologically a variant of the property rights approach.[123] Transaction costs will be considered as an important argument within the presentation of the 'property rights' approach.

1. 'Property Rights' approach and Coase theorem

The property rights approach, like that of welfare economics, takes as its starting point an individualistc idea of man.[124] It assumes that human beings endeavour to apply both their abilities and the economic resources to satisfy their needs. Problems arise where this individualistic behaviour affects others. In such conflict situations it becomes necessary to specify the individual´s rights. This may be done by means of socially accepted norms, conventions, traditions, or positive law; or it will be achieved through

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122 Albert, 'Modell-Denken und historische Wirklichkeit', in Albert (ed) 'Ökonomisches Denken und soziale Ordnung', Tübingen, 1978, 39-61 at 58; see Schörner op cit at 101 note 146 for the interesting relation between this criticism and the entrepreneur-approach by Schumpeter.

123 Schüller, 'Property Rights, Theorie der Firma und wettbewerbliches Marktsystem', in Schüller (ed) 'Property Rights und ökonomische Theorie', München, 1983, 145 at 161 et seq.

124 Schüller, 'Einführung', in Schüller (ed) (Ökonomische Theorie), VII-XXI at VII.

contracts which provide for institutional business restrictions.[125] However accomplished, other individuals will be excluded from using one individual´s property rights.[126] It is at once obvious that 'institutional' rules which confer property rights are not - as they are, for example, in the equilibrium and (partial) pareto models - mere given data.[127] This has important implications for the regulation of insider dealing: for example, a manager´s use of special information in stock market transactions (ie a property right to use the information) affects the market differently from an insider dealing prohibition placed on the same manager by the law.[128]

The Coase-theorem[129] provides a criterion to determine the efficiency of alternative legal options. It states that, irrespective of what the initial distribution, neither allocative efficiency nor pareto optimum are affected in a negative way, if the following conditions are met: (i) there is complete competition on the examined market; (ii) the initial distribution consists of fungible property rights; and (iii) there are no transaction costs.[130]

This suggests that privately negotiated solutions will also lead to real (and not merely fictitious)[131] compensation and pareto efficiency. This approach, unlike the approach of welfare economics, allows us to recognise the private component of external effects (eg of rules regulating property rights). Where negotiation costs are absent, one may therefore speak of the internalisation of external effects. This makes it obvious that public or political change is only *one* possible solution. It also makes obvious that it is by no means self-evident that a public solution is any better than a private one achieved by means of contracts. This finding is of great significance for the legal recommendations suggested at the conclusion of this thesis.

The property rights approach also has a normative aspect, namely, the policy of saving economic resources by means of decreasing transaction

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125 Schüller at VII.

126 See Demsetz, 'Toward a theory of property rights', 57 (1967) The American Economic Review, Papers and Proceedings 347-359 at 347.

127 Schüller at VII.

128 Schörner op cit at 102.

129 See above all Coase, 'The problem of social cost', 3 (1960) The Journal of Law and Economics 1 at 6-8.

130 See for an overview Schörner op cit at 103.

131 See above footnote 94.

costs.[132] Therefore, all insider (non-)[133] regulations must be examined in terms of decreased or increased transaction costs.[134] Of course, the success of such an examination depends to a large extent upon how 'transaction costs' are defined. Unfortunately, 'transaction costs' is one of the undefined terms of economic literature.[135] For example, are the costs of information supply and information analysis, specification and distribution of property rights, monitoring and negotiation costs, to be included in the definition of transaction costs?[136] It would seem that costs related to information must be included; and indeed the inclusion of such costs marks an important step forward from the theory of welfare economics.

Yet it remains very difficult or even impossible to determine precisely the costs of information. The reason for this difficulty is that we must know all informational sources, their prices, and their quality.[137] If these data are not available, we will not be able to optimise our informational activities (ie discover information sources, determe their quality, and so on). Logically, this could lead us into an infinite cycle[138]: optaining information and evaluating it both generates costs - yet, at the same time we would have to determine the cost of the informational status-quo. This is logically impossible. So, what needs to be done?

a) Failure of attempts to compare the efficiency of insider regulations exclusively in terms of transaction costs

A model which is entirely based on transaction costs will fail. In the present social situation (ie with the 'invariable' that our societies are non-determined in the sense that Popper gives to the term) we cannot quantify

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132 Schüller 'Einführung' at XVI et seq.

133 My addition.

134 Schörner at 103.

135 Schörner at 104.

136 Michaelis, 'Organisation unternehmerischer Aufgaben - Transaktionskosten als Beurteilungskriterium' Frankfurt/M, 1985 at 80, and at 95-100; see also Wegehenkel, 'Transaktionskosten, Wirtschaftssystem und Unternehmertum', Tübingen, 1980 at 15 et seq.

137 See Schörner at 104.

138 This basic methodological problem is explained by Popper in 'Das Elend des Historizismus', 3rd ed, Tübingen, 1971 at XI.

informational costs. For in order to do that we would have to determine the price of an insurance which covers informational risks. 'Informational risk' is a lack of knowledge about the effects of human incorporated in a plan model.[139] Whenever there are informational risks, these insurance costs cannot be specified. Insider regulations (or, alternatively, non-regulations) attempt to minimise informational costs, for instance, research costs incurred by outsider shareholders in order to find out whether or not there are insider transactions in certain shares.

Market prices for insurances (which cover informational risks) need to be determined within the legal framework. Insider regulations are part of this legal framework. Therefore, the contribution of insider regulations to the reduction of transaction costs cannot be measured by a transaction cost model that is unable to quantify the informational risk. Again we have an infinite cycle[140]: no unregulated market can provide us with any information about transaction costs in a regulated market.

Even though in most cases there is no determination of the exact transaction costs,[141] the literature on transaction costs has made some additional suggestions. One of them is that the law-making process should result in well-defined statutes. Where that is not the case, there will be danger of contravention of the law (and subsequent penalties) both of which would lead to increased informational costs.[142] This, however, is a task not for an economist, but for a lawyer. Hence there is no further economic argument.

What we can learn from these transaction cost arguments is that, for the sake of all participants in capital markets, any regulation should provide clearcut definitions which clarify who may or may not deal, and on which information.[143] Moreover, as we have seen, the argument that (non-) rights approach. regulation will lead to a cost-reduction, must be viewed with care and some suspicion.

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139 Where it can be incorporated, however, it must be 'insecurity which can be handled with', see Schneider, 'Allgemeine Betriebswirtschaftslehre', 3rd ed, München, 1987 at 2. Such insecurities are one basic condition for the existence of complete markets, see Schneider at 468 et seq.

140 Schörner at 104 et seq.

141 Schörner at 105.

142 Wegehenkel, 'Coase-Theorem und Marktsystem', Tübingen, 1980 at 33-36.

143 See Schörner at 106.

b) A Coasian Model versus the old-fashioned argument that insider trading is detrimental to other market participants

Most lawyers[144] who favour insider dealing prohibitions assume that, in one way or another, the outsider party to the insider transaction suffers a loss (economically). They conclude therefore that insider trading should be prohibited (legally).

However, the term 'loss' in the sense used by lawyers needs to be re-considered in terms of the property rights approach. Here, the second theorem of welfare economics must be remembered. Only if one can distinguish between the original distribution of property rights and the efficiency of resource allocation, is it possible to ignore the allocational effects of property rights distribution (eg through insider regulation). As we have seen above, however, this is not possible, because any initial distribution of property rights is equally efficient (Coase theorem). Therefore, the distribution of property rights (and obligations) should be carried out in such a way that the total economical efficiency gain is as large as possible.[145]

In terms of such an approach - which considers the total economic effect - any restriction means a 'loss' to at least one acting party. If the restriction is placed on insiders, then insiders suffers a loss[146] (ie that they cannot exploit the value of their information). Yet it has never been proved that non-insiders (plus their expectations) must be 'protected' in order to foster the overall economic development.

'Loss' bears a reciprocal character[147] in a situation where a distribution of rights and obligations is carried out. In order to justify restrictions for insiders it would be necessary to prove that this is better for the economy.

In our world, where we certainly have an initial distribution of (property) rights, we could speak of loss or damage only when well-founded expectations are not fulfilled, for instance when the parties to a contract undertake not to deal on inside information, but one of them nevertheless does so. But our concern is whether or not the distribution of property

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144 See Hopt/Will, 'Europäisches Insiderrecht', Stuttgart, 1973 at 46-48.

145 Coase op cit (social cost) at 15-19, see also ibid at 43 et seq.

146 See Schörner at 107.

147 Coase, ibid at 2.

rights should be changed through insider dealing regulation. Hence there is originally no such expectation. Therefore, we cannot speak of a damage or a loss. The (re-) distribution of property rights must, on the contrary, be founded on an examination of the following question: who, (insiders or non-insiders) is to suffer a 'loss' (and to what extent)[148] so as to improve the economic situation as a whole.[149]

Yet no such examination has sufficiently proved that damage to either side is beneficial for the economy as a whole. Supporters of the school of thought based on the 'property rights' distribution, remain rather vague when it comes to general statements concerning the initial distribution of property rights.[150] Only one important new approach has been developed, namely is the economic analysis of law[151] (Chicago Law School). This approach will be dealt with in the following subsection.

2. Economic analysis of law - the Chicago School of Law

The Chicago School of Law utilises the property rights approach yet pursues the goal of moulding legal norms in such a way that the economy as a whole benefits.[152]

a) An efficiency approach

Their approach includes the decrease of transaction costs and, what seems to be very important, it bases itself on the assumption that voluntary market transactions lead to an improved efficiency. In their view the distribution of rights should equal the distribution which the participants in the markets would have chosen.[153] An optimal distribution exists where exactly those rights are conferred to each market participant which he would have

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148 My addition.

149 See Coase, ibid at 2.

150 See Schörner at 108.

151 For an excellent overview see Wegehenkel (Coase Theorem) at 33 et seq.

152 Schneider, 'Investition, Finanzierung und Besteuerung', 6th ed, Wiesbaden, 1989 at 546.

153 Posner, 'Economic analysis of law', 3rd ed, Boston, Toronto, 1986 at 11-14 and at 43-48; see Posner, 'The economics of justice', Cambridge, London, 1981 at 71.

acquired for himself without distribution.[154] This concept is based on the idea that voluntary market transactions lead to more efficiency.

It seems appropriate to adopt this approach in order to determine who may use inside information.[155] One would have to ask who would (for instance in an auction) bid the most in order to acquire the right to exploit such information. However, a general prohibiton of insider trading could not be based on this approach. Regulating insider trading or not boils down to the question of whether we want inside knowledge to be exploited. Therefore, for such a fictitious auction to be representative, there would have to be a bidder with the interest to pay for the non-use of information. However, this bidder´s money would be completely wasted. In economic theory we find models of such auctions for the right to pollute the air (for instance for the chemical industry). It is assumed that only a limited amount of toxins can be used, and firms must acquire the property right to use them. In that case, it makes sense for some bidders (for instance interested environmental groups) to bid and then not use the acquired right to pollute. The non-use of information, however, has no such positive side-effects as is for example the non-pollution of the air. Hence, nobody would bid.

Albeit theoretically promising, the approach based on such a model market evaluation is not capable of solving important methodological and informational problems. Firstly, the market transaction is only in an abstract model. No real compensation is paid to the other individuals in the market. This in itself is a contravention against the pareto criteria. We have discussed the problem of the 'missing compensation' in the subsection on welfare economics: without the duty to compensate there is redistribution of wealth (property rights) which is exactly the opposite of what we want.[156] For this reason alone the approach has to be discarded.

Secondly, it would be too difficult for the legislator to obtain information about any efficiency-increase because, in market transactions which are only simulated (in models), the benefit to the individual market participants

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154 Posner, (Analysis) at 11-48.

155 Schörner at 109.

156 See Coleman, 'The economic analysis of law', in Pennock/Chapman (ed), 'Ethics, economics and the law', Nomos 24, London, New York 1982 at 83-103; Posner, (Justice) at 93 et seq.; see also Sohmen note 116 ibid.

remains uncertain.[157] This again is an 'infinite cycle' problem of the kind we encountered earlier in the section on property rights (ie obtaining information about a situation which could only come into existence with that information, for instance transaction costs in non-regulated markets where the market is still regulated). Therefore, the economic analysis of (any) proposed insider dealing law is not very promising.

b) Conclusions for insider dealing regulations

Examining the insider dealing problem in terms of the economic analysis of law reveals once more that any juristic argument favouring prohibition on the ground that insider dealing allegedly damages other participants, is not well-founded.[158] Paying a higher sum for the non-use of information is unacceptable because then the possible benefits of the information would be lost. The question is, rather, who should exploit the value of the information. Any other conclusion implies that information as such is not beneficial. The hypothesis that information is useful and beneficial shall, however, not be put in question.

Therefore, the economic analysis adds to the view that prohibition is not necessarily beneficial. Yet the Chicago School of Law does not really have an argument for a proper solution of our problem. Neither transaction cost minimisation nor model-market transactions can prove that the prohibition of insider trading is either necessary or superfluous. The general problem is that the economic theories examined so far have tried to cope with external costs through external mechanisms (regulation, granting more or less freedom, and so on). We shall now turn to another model approach which offers an internalisation of external costs.

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157 Coleman ibid at 84 and 97 et seq.

158 Schörner at 109.

3. Principal-Agent-Models

Principal-Agent-theory (also called 'agency theory') examines agency relations between at least one principal and one agent.[159] The theory assumes two features to be common in these relationships. Firstly, that both parties pursue their own goals through their relationship, and secondly, that there is a situation of asymmetrical information distribution between the two.[160] The principal depends on the action of the agent.[161] The agent makes decisions which bind the principal - hence his informational advantage over the latter. A typical example of this is the relationship between managers (as agents) and shareholders (as principals). It is due to this informational imbalance that insider dealing by the agent becomes possible.

a) Positive theory of agency and agency costs

According to Jensen[162] we have to distinguish between two different methodological approaches, ie the 'positive theory of agency', which is mathematically and non-empirically oriented, and the principal-agent approach[163] The tool in terms of which institutional regulations are analysed is referred to as 'agency costs'. The sum of the agency costs is the overall utility decrease due to informational imbalance between principal and agent. To evaluate the utility, these theories use as a parameter, or rather as a point of reference, an 'ideal world' in which there is an informational equilibrium, ie homogenous expectations of all market participants.

Agency costs (general definition: the difference between shareholder wealth

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159 For an excellent overview see Pratt/Zeckhauser (eds), 'Principals and agents: The structure of business', Boston, 1985; the terminology is owed to Ross, 'The economic theory of agency: The principal´s problem', 63 (1973) The American Economic Review, Papers and Proceedings at 134-139.

160 Jensen/Meckling, 'Theory of the firm: Managerial behavior, agency costs and ownership structure, 3 (1976) Journ of Financial Economics 305 at 308.

161 Pratt/Zeckhauser, 'Principals and agents: an overview', Pratt/Zeckhauser op cit at 2.

162 Jensen, 'Organization theory and methodology', 58 (1983) The Accounting Review 319 at 334 et seq.

163 Jensen ibid at 334.

when the management acts exclusively in the shareholders´interest, and when managers maximise their own benefits) can be subdivided into three different types of costs.[164] Firstly, and most obviously, there are monitoring expenditures, for the principal certainly needs to control what transactions are carried out in his name. Secondly, there are so-called bonding expenditures. These are costs incurred by the the agent. 'Self-bonding' costs, for instance, are incurred when the agent signs a contract by virtue of which he is not allowed to be an agent for someone else (eg refrain from competitive business); or he shares the economic risk of the principal (eg loss of bonus if the share price of the company is below a certain price). Thirdly, every agency relation implies certain residual losses inspite of monitoring and incentives,[165] eg information costs to keep the principal informed.

In recent research this approach has been most important for the question of the institutional regulations in enterprises.[166] The hypothesis here is that in a competitive world only those institutions will survive which generate the least agency costs (so-called 'survival approach'[167]).[168] Hence the question: what measures will bring about a reduction of agency costs? In a firm, this requires the introduction of incentives and controls.

It is also necessary to analyse the effects of regulations upon the individual benefits of the co-contractants. These effects are called 'retro-action on control markets', control markets for managers (ie the labour market for managers), and the market for corporate control. These control markets will be considered once we have discussed some more general aspects.

b) The principal-agent-approach

Before we turn to agency models for insider dealing, it is necessary to broaden the basis of our inquiry. The principal-agent-approach is also

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164 Jensen/Meckling op cit at 308; for the general definition see for instance Menichetti, 'Aktien-Optionsprogramme für das Top-Management', DB 1996, 1688 at 1689.

165 See Schörner at 111.

166 See Fama/Jensen 'Separation of ownership and control', 26 (1983) The Journal of Law and Economics at 301-325

167 See Reder, 'Chicago economics: Permanence and change', 20 (1982) The Journal of Economic Literature 1 at 24 et seq.

168 Fama/Jensen at 301 et seq.

mathematical and formalised. It examines incentives and risk distribution in contracts. We want to know which informational advantage of the agent (and maybe also the use of this insider knowledge) will result in an optimal risk distribution between principal and agent.[169] This is very important in order to determine the extent to which the manager must disclose information to his principal. Disclosure would immediately hinder his dealing on the strength of the information, because its exploitable value would be gone. This approach allows for a new kinds of parameters, namely the salary and incentives (eg the production of inside information) which can be included in managerial contracts. Thus contracts help to create a situation where external costs (eg monitoring insiders) are internalised. This could render administrative monitoring (of insiders) and, consequently, legal insider prohibition superfluous.

c) Problems posed by the agency model analysis, particularly moral hazard and adverse selection

Before we can endeavour to outline a convincing approach to insider dealing we must examine more closely the general and specific problems of agency models.

Every agency approach faces certain inherent general problems: the first of these problems being that agency costs (ie monitoring, bonding, and residual expenditures) used as criteria for economic decisions are also 'opportunity costs'[170], ie costs which are meant to measure the amount of lost benefits, for instance, residual information costs. It is very difficult to determine these costs in situations without a general competitive equilibrium,[171] which is what we want to achieve through regulation. Such an equilibrium, however, is needed to calculate the abovementioned costs (similar to the information costs in the transaction cost model!) in terms of insurance primes. We do not have such an equilibrium in our markets - that is why we ask which form of (non-) regulation of insider dealing will help to find this equilibrium. Yet, here again we have an infinite cycle problem: it is impossible to compare different insider rules (either allowing or

169 Jensen (organization) at 334.

170 For this term see Schörner at 105.

171 Buchanan, 'Cost and choice', Chicago, 1969 at 5 et seq., and at 84-102; see also Schörner at 105 and at 112.

prohibiting insider trading) in terms of costs - no matter whether they are transaction or agency costs.[172]

Having presented the general objection which can be made towards agency models, we shall now analyse two more specific problems of agency relations: 'moral hazard'[173] and 'adverse selection'. Moral hazard is the possibility of the agent increasing his own utility to the detriment of the principal´s. The basic problem in this regard is that whenever the firm performs poorly, it is very difficult to determine whether this is due to managerial misbehaviour or to an exogenous incident. Either specific control systems or special salary agreements are needed in order to prevent the manager from profiting unduly.[174]

This gives rise to the question whether, if insider dealing is allowed, the manager will be enabled to benefit himself at the expense of the shareholder (like other so called 'fringe benefits' such as less working hours, a car, or business lunches[175]). In terms of the moral hazard problem, one has to examine the following aspects of a managerial contract: incentives, risk-sharing with the shareholders, and possible cuts in salary which are compensated through allowing insider dealing.

The second problem is what economists call 'adverse selection'. Due to asymmetric information distribution amongst prospective parties to contracts, there is a negative selection process from the point of view of the quality of the products (or rights) which are sold.[176] Why negative? The potential buyers of second-hand cars, for example, know the average quality of all such cars offered in the market, and are therefore willing to pay only the average price. Potential sellers with better cars than average

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172 Schneider, 'Agency costs and transaction costs', in Bamberg/Spremann (eds), 'Agency theory, information, and incentives', Heidelberg, 1987 at 481-494.

173 Above all see Arrow, 'The economics of moral hazard; Further comment', in Arrow, 'Essays in the theory of risk-bearing', 2nd print, Amsterdam, 1974 at 212-222.

174 This is not a new problem. See already Adam Smith, 'An inquiry into the causes of the wealth of nations', edited by Campbell, Oxford, 1976, vol 2 at 741 put it like this: '... being the managers rather of other people´s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery watch over their own.'

175 See for these examples Schörner op cit at 113.

176 Boadway/Bruce, 'Welfare economics', New York, 1984 at 123-129.

will refrain from selling because they can only contract at the average price. Hence the average quality will be reduced as a consequence of their reaction; and potential buyers reduce their offered average price. And so on, until the cars offered are of worst available quality.[177]

Mechanisms which can stop the negative selection process are 'signalling' and 'screening'.[178] 'Screening' means that the market participant with less information can apply certain tests to verify the quality of products offered. 'Signalling' is the other side of the coin. The better-informed seller of better (than average) products sends out certain signals to potential buyers which can be traced by them without being copied by sellers of average products.[179]

The adverse selection analysis can also be applied in order to compare different (legal) insider dealing approaches and their effects on the efficiency of capital markets. Because the negative selection is due to asymmetric information, any legal solution must allow new information to be distributed as quickly as possible amongst all market participants. Certainly, this goal is not achieved by a 'disclose or abstain' policy, because the insider who follows this rule is more likely to abstain. Hence the rule will definitely not result in a quick supply of new information. Insider trading, on the other hand, can incorporate new data in share prices. Therefore, it should be seen, not so much as an 'evil', but as an economic feature which may bring about beneficial effects for the market-process. We shall now examine these processes.

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177 Akerlof, 'The market for lemons: Quality uncertainty and the market mechanism', 84 (1970) The Quaterly Journal of Economics at 488-500.

178 For an application of this 'lemon'-phenomenon to capital markets see Ross, 'The determination of financial structure: The incentive-signalling approach', 8 (1977) The Bell Journal of Economics at 23-40.

179 See Stiglitz, 'The theory of 'screening', Education, and the distribution of income', 65 (1975) The American Economic Review at 283-300.

IV. Markets and process-oriented Models

Thus far we have considered the conceptual change from equilibrium approaches to efficiency-oriented approaches. Both approaches did not look upon competition as a process in itself. Economists referring to Hayek[180] considered that competition as such is a process which helps to discover new information for economic plans.[181]

With regard to insider dealing it is interesting to note that the equilibrium approaches never really examined the *process* through which homogenous information (ie an informational equilibrium) is achieved.[182] In the new process-oriented approach, however, unequal distribution of information is itself the basis for a discovery process[183] in markets.

Markets facilitate this discovery process. It is of crucial importance to understand that markets are the institutions where - through the possibility of gaining from arbitrage trading - the process of information-discovery takes place. Organised capital markets help reduce informational risks, and thus achieve better allocation of limited resources; and hence render the future less insecure (in terms of expectations of the market participants).[184]

In the course of our examination of market process analysis we shall explain institutional rules with reference to the enterpreneur and his function in competitive markets.[185] Schumpeter's view was that the entrepreneur always destroys the pre-existing equilibrium. This, however, is regarded as positive for the developement of the economy because a new equilibrium is going to be achieved at a higher level of information (eg technical production skills).

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180 Hayek, 'Der Wettbewerb als Entdeckungsverfahren', in Hayek (ed), 'Freiburger Studien', Tübingen, 1969 at 249-265.

181 Hayek, ibid at 249 and at 253 et seq.

182 Shackle, 'Epistemics and economics', Cambridge, 1972 at 447.

183 Schneider op cit (Betriebswirtschaftslehre) at 514 et seq.

184 Schneider, 'Die Erklärung hierarchischer Unternehmensorganisationen', in Leipold/Schüller (eds), 'Zur Interdependenz von Unternehmens- und Wirtschaftsordnung' at 41-65.

185 Schumpeter, 'Theorie der wirtschaftlichen Entwicklung', Berlin, 1964.

1. Complete competition as a normative parameter

The theory known as '*Ordoliberalismus* '[186] states that a liberal approach towards the economy within an '*Ordnungsrahmen* ' ('framework of order') set by the State) must result in both freedom and economic developement. 'Complete competition' according to this theory encompasses only the free access to markets for all interested parties. Prices are not determined by the market process (ie through competition), but they are regarded as given data because the access to the market is what counts. Today this seems unacceptable, because, if such perfect competition were achieved, the function of competition (ie the dynamic process of discovery) would automatically come to an end.[187]

Yet *Ordoliberalismus* is os importance for insider dealing. It says that it is the task of the state to secure competition. Although not explicitly expressed in the context of insider trading, ordoliberal recommendations for a competitive 'framework of order' are relevant to the insider prohibition discussion. Namely, the following measures are recommended:

1. Laws created by organisations and institutional units must be viewed with a critical eye. Parliamentary legislation should reduce the law-making power of such organisations, because they do not normally lead to any just balance of interests, but tend to create a one-sided distribution of rights.[188]
2. No distortion of prices should be allowed.[189]
3. Open markets with strong anti-monopoly policies ought to be created, and patent protection should be reduced.[190]
4. The freedom of contract should be limited only where it is misused in

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186 Schörner op cit at 117 calls it the German variant of *neoliberalism* .

187 See Hayek, 'Der Sinn des Wettbewerbs', in Hayek (ed), 'Individualismus und wirtschaftliche Ordnung', 1976, Salzburg at 125; Albert, 'Modell-Denken und historische Wirklichkeit', in Albert (ed), 'Ökonomisches Denken und soziale Ordnung', Tübingen, 1984, 39 at 42-47.

188 Böhm, 'Die Ordnung der Wirtschaft als geschichtliche Aufgabe', Berlin, 1937 at 158; Großmann-Doerth, 'Selbstgeschaffenes Recht der Wirtschaft', Freiburg, 1933.

189 Ibid at 380.

190 See Eucken, 'Grundsätze der Wirtschaftspolitik', 2nd ed, Zürich, 1955 at 9, 30-43, 229 et seq., 269, 291-299.

order to negatively affect competition.[191]

Above all, it is an anti-monopoly policy which contributes to our insider problem, because inside information creates, although only for a limited time, an informational monopoly situation.[192] One might be tempted to think that the use of insider knowledge (being a kind of patentable knowledge, for instance about a new range of products) is to be limited in terms of both anti-monopoly and the reduction of patents. But is such an application of the basic ideas of this economic approach to insider dealing appropriate? We must keep in mind that the main purpose of this theory is to enhance perfect competition in the sense of accessability of markets - an aim which is not suitable for modern process-oriented capital markets, because it would stop the 'discovery-process' that leads to new information. This alone makes an application undesirable.

The central role of contractual solutions is important for insider dealing, and in particular for the solution which will be submitted. Each individual (or insider) has the right either to transact in securities or to bind himself not to do so via (managerial) contract. Self-binding is necessary only if insider dealing is in any way detrimental - and thus such a restriction of contractual freedom is justified.[193] Again, to prove this, one would need a convincing argument either in favour of or against the beneficial effect of insider dealing. Alternatively, one can envisage a contractual solution which does not completely exclude (State) regulation. The latter is appropriate as long as we do not have a convincing economic explanation. As long as uncertainty prevails about the effects of insider trading one should offer the greatest possible variety of options to the market participants.

2. The competitive process detects new information

Once equilibrium-thinking was discarded, the New Austrian School[194] of thought put forward an opposing theory. Hayek[195] pointed out that, because

191 Ibid, at 275-279

192 Schörner op cit at 121.

193 Schöner op cit at 122.

194 See Kirzner, 'The Austrian School of Economics', in Eatwell et al (eds), The New Palgrave, vol 1, London, 1987 at 145-151.

195 'Die Verwertung des Wissens in der Gesellschaft', in Hayek (ed), 'Individualismus

human knowledge is limited, there can be no equilibrium. Because knowledge is necessarily limited, some expectations will always be disappointed. This leads to further adjustments of both behaviour and new expectations. Therefore, the term 'equilibrium' can be applied only to individual persons. Whenever the 'homo oeconomicus' meets with deviations from his plans and expectations he will readjust those.[196] When more and more people start to adjust their expectations, there will be a tendency for these expectations to coincide, thus leading towards equilibrium.[197]

It is very important for our inquiry that the medium through which people achieve more knowledge is the price structure. Because prices reflect the share value and heterogenous expectations about the future (eg future earnings). The price mechanism works as long as insider facts can influence the actions of other investors, at least indirectly: the other investors detect the existence of such facts through the transactions of the better informed (eg insiders).[198] The result of such a processes is what Hayek calls '*Spontane Ordnung* ' (engl.: spontaneous order)[199] because such an order is the result of many transactions based on different expectations.

3. 'Spontaneous order' versus positive rules

Together with this spontaneous order there are also abstract rules of conduct. Apart from genetically innate and traditional rules passed down to us, we consciously accept and modify social rules.[200] Within this system of rules human beings can form expectations because they know fragments of the whole; expectations which will turn out to have been partially correct, others need to be adjusted[201] on the new informational level.

This theory was applied to the insider dealing problem.[202] This gave rise to the question of whether or not it is desirable to prohibit dealing on hidden

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und wirtschaftliche Ordnung', 2nd ed, Salzburg, 1976, 103 at 120 et seq.

196 Hayek, 'Wirtschaftstheorie' at 52 et seq.

197 Ibid, at 63 et seq.

198 Hayek, 'Gesetzgebung' at 169 et seq.

199 The German term is 'Spontane Ordnung', used by Hayek, (Recht) at 59.

200 Hayek, (Recht) at 107-125.

201 Hayek, ibid, at 57.

202 Kirzner, 'Perception, opportunity, and profit', 1979 at 208 f., 254 , 263.

information. The parameter used is the enhancement of the discovery process. Kirzner explicitly refers to Manne, whose theory against the prohibition of insider dealing will be dealt with later. Kirzner argues that, firstly, it is pointless to criticise any action on moral grounds without a deep reflection on the possible benefits from these actions.[203] Secondly, he argues that one could look upon insider dealing profits as an example of managerial creativity and as real entrepreneurial profits. Here we have for the first time, at least implicitly, a positive assessment of insider dealing in an economic school of thought: entrepreneurial gains are the basis for competitive processes through which information is transmitted; and hence bring about a tendency towards the desired equilibrium.[204]

In a further step, the authors of the New Austrian School ought to provide criteria for the conscious formation of rules. Such criteria are needed in order to ensure that the selective process does not degenerate into a naive survival approach[205] according to which only those groups survive which coincidentally chance upon the 'right' rules (which seem to be *right* because they survive). In truth, it is impossible to define criteria for such an *Ordnungsrahmen* .

It is also clear that there has never been a natural development of rules either favouring or prejudicing individual interest groups. On the contrary, most rules have not come into existence through a selection process. Rather, they owe their existence to the intention to protect the interests of some group. Disclosure rules are a good example of this 'non-evolution' approach.[206] Companies and insiders would certainly prefer to conceal some information for as long as possible. Yet all potential shareholders want information, and it is vital for the market that this need is fulfilled. Hence disclosure rules have had to be formulated to balance out the interests involved.

At the end of the day one must admit that, very much like the freedom

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203 Kirzner, ibid at 104 et seq., note 21.

204 Kirzner op cit (Perception) at 3-12.

205 Giersch, 'Die Ethik der Wirtschaftsfreiheit', in Vaubel/Barbier (eds), 'Handbuch der Marktwirtschaft', Pfullingen, 1986 at 12.

206 See Schneider op cit (Betriebswirtschaftslehre) at 439-458; critical of such an evolution of rules also Vanberg, 'Evolution und spontane Ordnung', in Albert (ed), 'Ökonomisches Denken und soziale Ordnung', Tübingen, 1984, 83 at 96 et seq.

approach in economics, there is no valuable criterion for a positive system of rules. It is necessary to adopt a more modest approach towards analysing rules. One must start by simply taking into consideration their effects on market processes. It suffices for a policy (or rule), if its results in this process are more efficient than those of other rules. The justification of a legal rule is, in this perspective, its beneficial effect.[207] But how to evaluate such effects?

4. How to evaluate the benefits of (insider-) rules?

According to process-concepts, rules can be evaluated only by measuring their effects on the markets. A rule is considered positive if it results in an increase of efficiency in the market. The real problem then is: how far can we increase efficiency.[208] In economic literature this problem has been named 'rules utilitarism'.[209] However, comparing efficiency levels of institutions such as the Stock Exchange (instead of measuring the beneficial effect of a rule on the whole economy as suggested by welfare approaches), lacks a reliable parameter. In other words it is extremely difficult to determine that a rule (or an institution) is more efficient? Besides, one has to define what efficiency shall mean.

In this regard the process-approach is similar to the theory that tried to define pareto improvements for individuals.[210] Due to informational problems it is impossible to measure the change of utility for all participants.[211] Thus, one has to evaluate the utility effect of alternative rules in such way that the effect on market process itself serves as the relevant criterion. Competition enhances the (information) discovery process only in situations where prices fully reflect the amount of information available to competitors. In other words, prices make

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207 Hayek op cit (Verfassung) at 191.

208 Hayek op cit (Gesetzgebung) at 34.

209 Yeager, 'Utility, rights, and contract', in Leube/Zlabinger (eds), 'Essays in Honor of F.A. Hayek', Wien, 1985, 61 at 71-76.

210 See Buchanan, 'A contractarian paradigm for applying economic theory, 65 (1975) The American Economic Review, Papers and Proceedings 225 at 227, who states that 'the economist ´s productivity lies in his ability to invent social rearrangement which will embody pareto-superior moves'.

211 See Schörner op cit at 129.

widespread knowledge available to all.[212] Spontaneous order exists because prices can adjust expectations, ie they reflect new informational levels.

As far as capital markets are concerned, it is necessary to examine the effects that alternative rules have on this function of market prices. With regard to insider dealing this means that the best regulation (or non-regulation) is the one which enhances the transmission of information through prices.[213]

It must be emphasised that in this model the pareto principle is modified. It is no longer used as a parameter for the increase of every individual's benefit increase, but only as a conceptual tool which takes into consideration the preferential systems which prevail in institutions[214] (eg the preference of German investors to buy shares of companies which pay a high dividend). This modification has the advantage that we no longer need to solve the problem of actual compensation payments (eg to those German shareholders who have invested in a company that pays a high dividend one year, but in the following year produces a loss).

Yet such (pareto) benefit increase can only be achieved in a situation where the members of our society agree on the aim of improving market mechanisms.[215] Whether there is such an agreement is, however, difficult to determine.[216] It is all the more difficult because group interests can easily come disguised as a reflection of the common interest. The problem here can also be described as 'institutional choice' problem: members of a society try to find out which institutions best serve their common interest. To solve this one might try to find an impartial person.[217] Not in the sense that one individual is elected to decide about rules, but in the sense that any person could be chosen at random. In a problem situation any person (randomly

212 Hayek op cit (Gesetzgebung) at 161.

213 Schörner at 129 et seq.

214 See De Alessi, 'Property rights, transaction costs, and x-efficiency: An essay in economic theory', 73 (1983) The American Economic Review at 64-81. The term 'conceptual tool' was in this context first used by Buchanan.

215 Buchanan op cit (paradigm) at 226 et seq.

216 Fritsch, 'Die Legitimation kollektiven Handelns in der neueren Vertragstheorie', in Boettcher (ed), 'Jahrbuch für Neue Politische Ökonomie' 31 at 54.

217 Harsanyi, 'Rational Behavior and bargaining equilibrium in social situations', Cambridge, 1977 at 49 et seq.

chosen) would agree that his possibilities to pursue personal goals are (at least equally) good.[218]

Thus the chance to realise individual aims becomes the parameter of efficiency[219] - a remarkable step away from the classical pareto approach according to which there is no overall improvement if only one person is worse off. 'Institutioanl choice' allows that some suffer losses - as long as they think that their chances to gain are as good as for other participants.

This implies an abstraction from the concrete interests of individuals who agree with an institutional choice because they are convinced that, on the whole, they will profit even though some might incur losses.[220] Eg individuals may think they suffer concrete losses to insiders - yet they are convinced that the market performs better when insiders are present; and that this results in an overall economic improvement because markets become informationally efficient.

It is therefore necessary to examine whether an insider regulation enhances informational efficiency. Here we are close to the 'discovery process' suggested by Hayek: there is improvement (eg through rules) if the chances of the unknown person (ie the investor who is not yet present in the market) are improved.[221] The 'unknown person' can also be the entrepreneur whose function it is to reduce uncertainty for the market participants.[222]

Thus, for an institutional choice between regulation and non-regulation of insider dealing we must examine whether they result in a reduction of uncertainty. Two aspects need to be considered: the impact of rules on the market process, and the impact on the principal-agent situation (ie informational imbalances).[223]

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218 Hayek op cit (Entdeckungsverfahren) at 255.

219 Cordato, 'The Austrian theory of efficiency and the role of government', 4 (1980) The Journal of Libertarian Studies 393 at 403.

220 Kirsch, 'Ordnungspolitik als Gegenstand', in Issing (ed), 'Zukunftsprobleme', Berlin, 1981, 255 at 272.

221 Hayek op cit (Entdeckungsverfahren) at 255.

222 Schneider op cit (Betriebswirtschaftslehre) at 1 and at 18 et seq.

223 See Schörner op cit at 135.

5. Summary and first conclusions for a democratic approach to insider trading

The economic theories we have examined, when applied to insider dealing, do not really bring us concrete results. Equilibrium models which imply that market participants have homogenous expectations, are to be discarded. They ignore the fact that in our world there are informational imbalances - as the principal-agent analysis has clearly proved. Thus we can accept only those theories which are based on the hypothesis of heterogenous expectations. That gives rise to the question whether regulation is needed at all. Economic theories address this question in different ways.

As we have seen, the freedom approach suggests that insider regulation is unnecessary. At the core of liberalism is the belief that measures should be relied upon as little as possible. This leads us to the efficiency theorem as a parameter to evaluate (non-) regulation. Unfortunately, the efficiency-oriented approaches do not result in concrete suggestions either. Their most important contribution to our discussion is to avoid 'nirvana' (ie non-realisable) approaches. When we compare the efficiency effects of rules, we have to compare institutions. For an evaluation of rules, the possibility of non-regulation must also be considered because that can result in more efficient allocation. This analysis can incorporate the positive aspects of both property rights and process approaches.

It is, however, impossible to evaluate norms on the basis of transaction costs as a parameter. Nevertheless, it is an argument in favour of one alternative if this cuts out costs. That again favours non-regulation because monitoring and detection are expensive and result in a higher tax burden. However, if the transaction cost approach is discarded, what alternatives are there? This question was relevant also for the micro-institutional approaches.

The methodological contribution of the efficiency models is the (partial) pareto principle, ie the increase of individual benefits. The problem here is that it is practically impossible to detect increases or decreases in individual benefits; this informational problem remains unresolved. On the premise that insiders suffer losses (when insider trading is not allowed) it became apparent that there must be a real compensation paid to them, for instance, a higher salary. The principal-agent approach suggests that they could as well trade and accept a cut in salary.

As long as compensation is not provided for in insider dealing regulations (and to date there is no such statute), we can use as a conceptual tool only the pareto principle which takes into consideration the 'unknown' person (anybody randomly chosen) to evaluate the benefits of a norm. This concept, based on Hayek, is process-oriented and holds that institutions (eg capital markets) work most efficiently when people think that their interests are best-protected - even though some might suffer losses.

The market approach examination has already contributed some interesting findings to our insider dealing problem: it revealed that, economically, it is not necessary to ban insider dealing. On the contrary, we learnt that process-analysis allows for some individual losses (if it is proved that insider dealing causes these losses), as long as the efficiency or the social benefit are enhanced. In that case everyone profits even though some individuals might suffer losses. In a nutshell, increase of the overall utility could mean losses for some.

It is also important to note that the process approach is, not without reason, sceptical about general rules designed by organisations or other social units. That explains why, at the end of the day, the old German insider dealing (non-legal) approach had to be rejected. It was implemented and monitored by organisations. As a result, no insider was ever found guilty of insider dealing. Those rules were in fact paper tigers.

Some parts of the current English insider dealing system have to be viewed with scepticism because it includes regulations designed by organisations such as the Self-Regulating Organisations (SROs, for example the Securities and Futures Authority (SFA); the Securities and Investment Board (SIB); and also to some extent the Panel of Take-over and their code.

We have also seen that, once one accepts that there is no overall economic solution to the insider problem, one must turn to market processes, and more specifically, to price functions. In order to evaluate insider regulations we have to measure their effects on prices, because these are indicators for informational efficiency. Entrepreneurs (and managers), who are the main producers of information, must also take into consideration the effect that insider regulation has on their firms. In this regard liberalism favours contractual solutions. That is in line with both the freedom approach ('less State') and transaction cost thinking (less monitoring costs).

Before we can start the legal examination, it is important to summarise the position of Manne. His views have an important influence on the legal discussion around insider dealing prohibitions.

V. Manne, his critics - and some conclusions for our democratic approach

Manne[224] presented his conceptual approach to insider trading in 1966.[225] Until then the conventional fairness/moral approach had prevailed in the USA without being put in question. His starting point was simple and reflected academic curiosity: 'What is so bad about insider trading?'.[226]

He considered fund management strategy in general. He pointed out that one way of exploiting new information causes no harm because it involves no transactions; many people don´t buy or don´t sell because they have inside information. Fund managers, for instance, do not sell when they have access to positive company data, although they originally planned to sell the stock. They will simply refrain from selling the shares that they would otherwise have sold. Economically, this has the same effect on the price as a decision to buy the same number of shares on the basis of inside information.[227] No one would try to enforce that these insiders sell their stock.

1. Protected interests in a prosperous society

Manne found that no-one with an important interest is harmed when insiders are allowed to trade.[228] On the contrary, many people are helped, because insiders cause the share price (prior to release of positive news) to begin rising earlier than it would have if they had not bought. Outsiders who sell while prices rise will get a higher return than they would have had there been no insider transactions. The share price reflects more accurately the value of the stock which is beneficial for allocative processes in general. Thus, unfettered insider trading will improve stock market 'continuity', ie the closeness between the prices at which consecutive transactions are

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224 See Manne, 'Should fund managers use inside information personally? Yes', (May 1967) The Institutional investor at 19 et seq.; Manne, 'Insider trading and the law professors', 23 (1970) Vanderbilt Law Review at 547 et seq.

225 1966 is the year not only of the publication of 'Insider trading and the stock market', but also of 'In defense of insider trading', Nov./Dec. 1966 Harvard Business Review at 113.

226 This is the title of an article by Manne, in Jan./Feb. 1967 Challenge at 14.

227 Manne op cit (Cato Journal) at 938.

228 Manne at 110.

executed. The price movement becomes relatively smooth. Critics have argued that such smoothness is not necessarily better than a sudden jump.[229]

Yet, people should decide this question for themselves: whether they prefer sudden price movements or smoothness will to a large extent depend on their personal risk-aversion. They ought to be given a democratic choice. More conservative investors may be hostile towards such sharp movements; and less conservative investors may be happy about such movements because they wish to take more risk and to benefit, from the possibility of generating high profits.

A system which offers both possibilities seems ideal. In fact, economic research since Manne wrote has shown that, in this regard, he was not completely right. As we shall see, price adjustment is not due to insiders but to so-called 'signalling effects'. The insider himself is not even 'guilty' of price movements, and therefore his transaction cannot cause harm.

Nevertheless, Manne´s main proposition - that no one is harmed - is valid. He was right, too, when he argued that short term buyers and sellers (eg chartists who act upon price movements) gain from insider trading.[230] This also creates incentives to deal and thus increases market liquidity.

Manne´s analysis has been subjected to criticism. To some it seems paradoxical that we should be urged to reverse both the theories and law which we have enabled us to achieve today´s prosperity and, now that we have unprecedented resources for effectuating our views of fairness, that we should be urged to allow practices long deemed unfair and unlawful.[231] This is a direct reply to Manne´s proposition that unregulated insider trading may be fundamental to the survival of our corporate system, and that it may be nothing less than the wellspring of American prosperity.[232]
We are not going to discuss here the wellsprings of our modern societies. Undoubtedly, Manne exaggerated.

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229 Schotland op cit at 1446.

230 Manne at 95, and again at 102.

231 Schotland at 1429.

232 Manne at 110.

Yet the counterargument is also not well-founded. Do we really know whether insiders refrained from trading prior to modern securities legislation, and that they did not trade afterwards? What we do know is that legislation was deemed to have become necessary - which seems to indicate that insider practices did prevail. And yet society prospered. Perhaps this prosperity is due to a shared feeling that all is well in capital markets.

This consideration is important for our pluralistic democratic approach to insider trading: whenever the majority believe that something needs to be regulated, then the law will eventually be changed - whether such change is theoretically sound or not. We should, however, make sure that such change is not brought about merely to promote the interests of a limted group; for then they tend to increase their own welfare and not the common welfare.

It is certainly wise policy to seek an explanation for a particular regulatory position in order to find out who will benefit most.[233] It is interesting to note that Manne detected those who profit most from insider restrictions: the financial service people, because they are next in line to gain access to information before the public at large does.[234] They trade before dissemination, and enjoy an advantage even over the disclosing insider.[235]

In order to ensure that all interests are treated equally, we must also take into consideration that market professionals, such as analysts, bankers, or fund managers, have an important function for the liquidity and the depth of the market. Neither regulation nor non-regulation models ought to deter their transactions.

2. Limited exploitability of information

Another point raised by Manne is that, because of practical limitations on the exploitability of inside information,[236] the insider will seldom be able to

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233 See Stigler 'The theory of economic regulation', 2 (1971) Bell Journal of Economics and Management Science at 3 et seq.

234 Manne op cit (Cato J) at 942. A recent study on the first noticable effects of the German WpHG confirms this, see Gerke/Bank/Lucht, 'Die Wirkungen des WpHG auf die Informationspolitik', 10/96 Die Bank 612 at 616.

235 Cf Levmore op cit at 126.

236 Manne at 78 et seq.

make a big profit. The most important limiting factors are: other information (eg political) which has influence on the stock price development; the time period to capture the fresh information which may be as little as a few minutes; the insiders's insufficient capital; his own uncertainty about the extent to which other insiders have already executed transactions; and the fact that occurence of significant opportunities to exploit information is on average once every ten years for each listed company[237]. This is another argument against the harm allegedly caused by insiders.

Of course, the insider can borrow money; and options (eg on indices) which demand less capital are available. Moreover, Manne[238] saw the possibility of a market for information. At the most informal level, this market would consist of, for example, two executives who are members of the same golf club. Another device for such a 'marketing' of inside knowledge would be a clearing-house for information where a person today might deposit information and tomorrow draw out non-public information deposited by other insiders. Investment bankers and underwriters would be able to function as 'clearing houses'.[239]

3. Entrepreneurial reward

In addition to the positive effects on market functions, Manne suggested that insider trading is necessary because it is the most appropriate form of compensation for entrepreneurial activity, eg innovation; for instance, an imaginative merger or sales campaign, a new product, or an improved method of financing.[240] Manne first distinguished the entrepreneur's task from that of the capitalist (who bears the financial risk), and from that of the manager (whose task is to do the 'predictable').

In our modern world technical progress is not so much the work of individuals but of teams and organisations. Thus the distinction between managers and entrepreneurs has become less important, but Manne's argument is still valid today. The original idea behind it does not seem to

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237 Ibid at 110.

238 Ibid at 63 et seq.

239 Ibid at 67.

240 Ibid at 131.

have lost appeal: without the entrepreneurs (or managing teams) being rewarded properly they will disappear, and with them finally the corporate organisation. Even the most bureaucratically-minded person may begin to have original ideas if the possibility of large rewards exists.[241] For this to be achieved a fixed salary is unsatisfactory because it is only appropriate for the purchase of a known or given service in the labour market.

Some critics have raised objections to this point. They argue that the proper reward could also be given as a bonus in a profit-sharing plan or as share options.[242] To this Manne replied that bonuses must be determined on an annual basis, while the effects of any given innovation may be very prolonged. It may not be apt to pay out a bonus when a company has actually lost money. Also, entrepreneurs tend to value their contribution to the company higher than others will.[243] That, however, is not too difficult: managers and firms must agree to enter into a contract (ie an interest equilibrium) - whether or not this includes an entrepreneurial reward.

Another objection is that some people may profit from the information who were not involved in the production of the new product.[244] To this Manne replied that it is possible for the company to isolate bookkeepers from the valuable information for as long as is necessary, and that this can be justified on the ground that they do not contribute to the new product. However, the contribution of an individual may be subtle, and one must therefore exercise caution concluding that no reward is deserved.[245] This has an important implication for the legal discussion: if we decide to ban

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241 Manne at 123.

242 Schotland op cit at 1436 at fn 39. A clear disadvantage of stock (and or option) programmes is that lower dividends will lead to higher prices of the shares - an incentive for the management to lower the dividend, both to the detriment of the shareholders. See Menichetti op cit (Optionsprogramme) at 1689.

243 Manne at 135. Another disadvantage of bonus-systems is that bonuses are balance-oriented, and balance sheets are also made for banks and do not always reflect the true state of affairs of the company, see Menichetti (Optionsprogramme) at 1689.

244 This is a variation of the 'free rider' problem: if persons can benefit from a good without paying for it, they will do so. If one cannot exclude those who do not pay for the good, no-one has an incentive to pay for it - hence no incentive to produce, and the good will not be supplied.

245 Manne at 157.

insider trading, we have to extend the definition of an 'insider' to encompass non-entrepreneurs and even non-corporate people. And indeed, later Manne extended his insider-definition to 'outsiders' in possession of non-public information.[246]

Another objection is that insider trading could undermine public confidence in the stock markets and the efforts to 'own your share of America'[247]. Yet if there is no plausible argument to prove that insider trading causes harm, then surely the sensible course of action is not to outlaw insider trading but to educate investors (so that they understand they are not harmed).[248] Then public confidence will not be undermined. Furthermore, why not also allow insiders to buy their share in companies? This would help solving the problem of separation of ownership and control.

It has been argued that it might be very difficult to isolate the value of the entrepreneurial act.[249] This view is not convincing, because the market itself will provide the insider with the exact amount of the reward. The information is worth exactly the difference between the price before and after announcement of the produced news item. The insider can freely choose when he trades. The risk that other factors dilute the effect of the information on the price is either with the company or with the insider.

Provisions must be made for this in the contractual agreement between company and manager.[250] Managers and companies are professional enough to bargain for their expectations. Doing that they already take into consideration factors like the situation of the particular branch of industry, performance of the company, or experience of the manager. Why should they be unable to do the same when they include the issue of insider dealing?

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246 See Kripke op cit at 950 et seq. for a criticism of this extension.

247 Cf Schotland op cit at 1440.

248 Cf Moore op cit at 177.

249 Schotland at 1454; see also Williamson, 'Corporate control and the theory of the firm', in Manne (ed), 'Economic policy and the regulation of corporate securities', Washington DC, 1969, 281 at 301-6.

250 A good argument against Kripke op cit at 955 (eg that such a procedure cannot lower negotiation costs) because once the contract is made it doesn't need annual revision.

In this context it has also been argued[251] that the reward is unpredictable. But that is to miss the point. If the entrepreneur or the manager is so conservative that he accepts only a (completely) fixed salary[252], then he will simply refrain from insider trading because of the risks involved. If he takes the risk, it creates an incentive to generate information in order to increase his income. The possibility that managers have different risk aversions and preferences suggests that they ought to be given the choice between these two alternatives. This is an important finding for the suggestions in view of a Model Code in Part III of this thesis.

4. Timely disclosure, moral hazard, and risks

Three further objections have been raised against Manne: the first is that insiders would delay disclosure because they first want to carry out their own transactions. The second is called 'moral hazard' and means the possible incentive for insiders to generate bad news on the strength of which they could also trade,[253] and which is obviously to the detriment of their companies. The third objection is that insiders who are allowed to trade might select riskier projects than the shareholders want because, if the risk pays off, they can capture a portion of the gains by insider trading, and if the project flops, the shareholders would bear the loss.[254]

The last of these objections can also be expressed in terms of market processes. The insider gains from volatility.[255] Insider trading normally decreases the day-to-day variance in the share price because price adjustment becomes less abrupt. This phenomenon may give insiders an incentive to increase the variance in their firm´s share price in order to create more trading opportunities.[256] For that purpose they might select riskier projects than the shareholders would prefer.[257] Manne[258] replied

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251 Schotland op cit at 1457.

252 This is suggested by Easterbrook op cit (Secret agents) at 332.

253 See Moore op cit at 178.

254 Easterbrook op cit at 332.

255 Easterbrook op cit (Agency) at 84.

256 Leftwich/Verrecchia, 'Insider trading and managers´ choice among risky projects', Chicago Grad. School of Business, Working Paper No 63, 1981.

257 Easterbrook op cit (Secret agents) at 332.

258 Op cit (Cato Journal) at 936.

that, for many reasons managers are, in truth, far too risk-averse.

Risk-aversion cannot really be the decisive factor in the debate. If it is known that a company allows insiders to trade, then outsiders can decide whether they are too risk-averse to become shareholders in such a company. All that is necessary is that investors be given clear notice of the fact that a particular company allows insiders to trade.

It must also be borne in mind that the risk-aversion argument can be viewed from a different perspective: the shareholder can diversify[259] his portfolio, and thus balance unsystematic risks. While he can at the same time invest in high risk companies and low risk firms, the manager risks his main source of income. The shareholder, on the other hand, can invest in different companies and thus diversify his risk. The manager may therefore even tend to act in a far more risk-averse fashion than the shareholder would wish.[260] Taking this into account, permitting insider trading might create incentives for the management to incur some more risks which would also be beneficial for the shareholders.

The penultimate objection concerns the disclosure issue. It is said fact that insiders delay disclosure because they still want to increase their profits before dissemination. But this argument is unconvincing. On the contrary, disclosure can be expected to be even more speedy where insiders trade.[261] As we have seen, the insider´s gains depend on the absorption of the information in the price of the shares. Yet this happens mainly at the time of disclosure. Thus the insider needs disclosure in order to realise profits. And if we accept that the insider´s financial means are limited, it will be in his interest to invest his money in the stock only as long as necessary. Thus it is in his interest to buy (or sell) and then disclose immediately, so that the price will adjust rapidly and yield its returns to him.

A serious problem would, however, seem to be the possible production of bad news (moral hazard). Such negative news may be just as valuable to the

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259 Even if he invests through financial intermediaries because most of them diversify to manage risk, see Smith, Thomas A., 'Institutions and entrepreneurs in American corporate finance', (85) California Law Rev 1997, 1 at 5.

260 See Schörner op cit at 232 et seq.

261 Manne at 152.

insider as positive information.[262] It is generally agreed that a reward for failures is as detrimental for a company as the consequent lack of single-minded dedication of a manager to his job which goes along with it.[263] In that case there would be a severe conflict of interest between shareholders and managers.

Manne rejects these objections. He points out that entrepreneurs (and also managers) are attracted to those positions offering the greatest opportunity for them to make large, indefinite gains, and these they can in the long run only achieve through good news. On the whole, good news is more likely than negative news,[264] firstly because the long-term trend of the stock prices is upward, so that, all other things being equal, occasions of good news should exceed those of bad. Secondly, bad news may tend to unfold in a more gradual fashion, or perhaps be anticipated, as is the case with a low earnings report or a dividend cut. Bad news may also more frequently be information affecting an entire industry and thus not be susceptible to individual managers.[265]

Manne´s reply to this objection may seem too simple. But his conclusion (eg that insider trading will not result in moral hazard problems) is nevertheless right, although not on the basis of his own arguments, but on the hypothesis of the modern economic theory of control market for managers ie that the labour market for managers will punish bad company performance (these markets will be dealt with later). In a situation where the insider acts to the detriment of his company, he will be liable for damages not on the ground of wrongful insider trading[266], but for breach of his duty of care and skill.

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262 Moore op cit at 178.

263 Schotland op cit at 1452 et seq.

264 Manne at 102.

265 Manne, ibid.

266 Remember that we discarded the misappropriation approach.

Chapter 3: A democratic approach to insider trading

We have considered the conclusions to be drawn from the main economic theories in regard to insider trading. We shall now suggest a new approach which incorporates these economic findings. This model may be called 'democratic' because it reflects the pluralistic opinions in our societies and is based upon self-responsibility. Its aim is to give capitalist investors, shareholders, and managers the greatest number of alternatives from which they may choose a solution that they deem the most appropriate. Based on this theoretical policy basis, the examination in Part Two of the present thesis we shall analyse different insider legislation; and we will then suggest a new juristic solution to the issue of insider dealing.

A. Important aspects of market processes and the protection of the market

We have seen in the previous chapter that the idea of banning insider trading on the assumption that individual market participants need protection is not convincing. Manne has focused our attention on the effects which insider dealing may have on the market process. With regard to this it is certainly not a coincidence that the European Directive on insider dealing[267] is explicitly based on the idea that '... for that market to be able to play its role effectively, every measure should be taken to ensure that market operates smoothly'. The assumption was, however, that insider trading is detrimental to this smooth operation. In the light of modern economic findings this assumption needs to be reconsidered. The aspects of market processes that we will examine will also provide further insight into economic data on insider trading.

I. The Efficient Capital Market Hypothesis (ECMH)

We have seen that insider trading may have an impact on the price movement of shares and options, and that this can be invoked as an argument in favour of such trading. It is necessary to understand how these prices are 'made'. Market´s efficiency is a function of the speed with which information is incorporated in prices.

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267 Op cit note 17.

1. Market mechanisms and absorption of new information

In the first place we have to examine the way in which information is incorporated in the prices of securities. This is also fundamental for the evaluation of legal concepts applied to insider trading. Of all recent developments in financial economics, the 'Efficient Capital Market Hypothesis' (EMCH) has achieved the widest acceptance by the legal culture.[268] We lack, however, a single, comprehensive explanation for the existence of market efficiency.[269] The most widely accepted definition of 'market efficiency' is that prices at any one time fully reflect all available information.[270]

As a device for classifying empirical tests of price behaviour, the ECMH is divided into 'weak', 'semi-strong', and 'strong' forms.[271] The weak form of the ECMH asserts that only past events which are available to *all* investors are reflected in share prices (ie the price does not reflect insider trading). According to the strong form, all information is at all times reflected. For the lawyer this is difficult to understand, because insider trading prohibition is based on the assumption that 'inside' information is not reflected in the share price.[272] According to the semi-strong version, the only type of information which is not reflected in the share price is inside information. All three forms of the ECMH were tested in both model and empirical studies; and none of them has been proved to be wrong.

The strong-form tests examine the extension of the hypothesis to information available only to particular groups of investors (ie insider

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268 Gilson and Kraakman, 'The mechanisms of market efficiency', (1984) 70 Virginia Law Review 549 at 549.

269 Gilson and Kraakman, idem at 553; also, very interestingly, Gordon/Kornhauser, 'Efficient markets, costly information, and securities research', NYULR, vol 60, 1985, 761 at 841 who mention tests that reject the EMCH altogether, suggesting that some price adjustments take place over two quarters (up to 26 weeks) following earning announcements.

270 Fama, 'Efficient capital markets: A review of theory and empirical work', (1970) 25 Journal of Finance 383 at 383.

271 Fama, idem at 388.

272 See Tippach op cit at 18.

information).[273] These tests suggested (although their results have been mixed)[274] that corporate insiders - such as officers, directors and affiliated bankers - can systematically outperform the market,[275] a fact which confirmed the semi-strong tests.

And indeed most empirical support has been in given to the semi-strong form. Unlike the weak form, which presumes that only information which is available to all traders is reflected in the share price[276] (ie 'old' information, such as price histories, as well as information about current events)[277], the semi-strong form shifts from 'publicly distributed' information to 'publicly available' information that is not known to all market participants.[278] According to this semi-strong from both economists and lawyers assume that markets are fully informed about the data which have been disclosed.

It is important to note that any prohibition of insider trading must assume the correctness of this semi-strong form of the ECMH because if the weak version were correct insider trading would not influence the price; yet we have seen that at least derivatively informed trading influences the price. Also, only under the semi-strong form there is the possibility of an informational imbalance between insiders and outsiders. The consequence of the assumption is that investors can confidently rely on the absence of any relevant informational imbalance when they trade in efficient markets. There is no need for outsiders to further analyse the market situation, because stocks are fairly priced, in the sense that there is no systematic

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273 Fama, idem at 409-412.

274 Gilson and Kraakman op cit at 556 fn 27.

275 Gilson and Kraakman, idem at 556 fn 27. If this were not the case, any prohibition imposed on insiders would make no sense, for it would prove that inside information is already reflected in share prices (there is, however, empirical research supporting the strong form). That would make any regulation superfluous, see Haddock/Macey, 'A coasian model of insider trading', (1987) 80 Northwestern University Law Rev 1449 at 1455 fn 13.

276 Fama op cit at 387 et seq.; Wang, 'Some arguments that the stock market is not efficient', (1986) 19 Univ of Cal Davis Law Review at 341; for more references see Carney op cit at 878 fn 71.

277 Carney op cit at 881.

278 Carney, idem at 881.

bias.[279] At the same time, insiders who are aware of information being disclosed can freely trade on it, confident that the courts will not find any unlawful informational advantage over other market participants.

Since insider regulation is based on the semi-strong form of the ECMH, the element of 'non-public' which recurs in all insider legislation must be defined in terms of disclosure. As we shall see later on, information can be 'public' even before disclosure.

Moving from information that is publicly available to firm-specific information which is not yet formally announced or released, price adjustments become more complex, and less well-documented.[280] Insider trading contributes to the price adjustment process because it reveals further information (eg when insiders buy the outsiders are made aware of the existence of positive news). That is exactly the 'information-discovery' process that was suggested by Hayek .

With regard to new information in general, it has to be noted that investors partly act as if markets were not efficient, and as if information can produce gains.[281] This has been described as the 'paradox of efficient markets'.[282] If there were no gains from investments in information, traders would not invest in research activities, and prices could not remain efficiently set.[283] Yet, why would anyone incur the cost of acquiring new information, if hair-triggered decoders (such as the price of a security) will reflect it anyway? The answer is that prices are not fully-informative and, indeed, that the acquisition effort is made precisely because they are not.[284]

A market where price decoding is both costless and accurate could not continue to support an efficient equilibrium in which prices fully-reflect trading information,[285] because such a market would offer no incentives to create this equilibrium. Such a market would 'sink into informational

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279 Carney, idem at 883.

280 For studies on price adjustments see Wang op cit at 364 fn 60 et seq.

281 Carney op cit at 883.

282 Grossman/Stiglitz, 'On the impossibility of informationally efficient markets', (1980) 70 American Economic Review 393 at 404.

283 Carney op cit at 883 fn 93.

284 Gilson and Kraakman op cit at 577.

285 Grossman/Stiglitz op cit at 395.

inefficiency' (ie lose its informational efficiency).[286] In other words, in order for the market to continue to be efficient, it must remain inefficient enough to create incentives for some market participants to search for new information. Efficient markets are never perfectly efficient markets.

From this follows that prices do not fully reflect information, and that it is the task of market participants (eg financial analysts) to decode more information from price movements. This finding also supports Manne's theory that insider dealing is beneficial for the market efficiency: insider trading as such is a potential further information that can be decoded by others - which eventually helps to make prices more efficient. Hence 'market protection' is a strong argument in favour of free insider trading rather than of prohibitions.

2. Insider trading and market efficiency

This subsection describes the mechanism through which insider trading makes prices more accurate than in a world without insider trading.

a) Price adjustment: movement from uncertainty to certainty

The distinction between 'hard' (ie certain) information and uncertain forecast, portrays a constant movement toward certainty as new data either confirms or alters the old information and thereby renders it 'new'.[287] Where knowledge is incomplete, uncertainty about future prospects will remain - until actual events resolve that uncertainty. Before that, trading activities (including insider transactions) will fine-tune the price, which finally reflects the 'consensus' of traders' assessments.[288] The consensus can be defined as the point where heterogenous expectations meet.

b) Capital asset pricing model: all shares are equally priced

In instances of monopolistic access to information (eg corporate insiders and exchange specialists), information first enters the market through a very small number of traders whose own resources are not large enough to

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286 Gilson and Kraakman op cit at 577.

287 Gilson and Kraakman at 563.

288 Gilson and Kraakman at 581-585.

induce speedy price equilibration[289] (note that this is also in line with the proposition made by Manne). But reflection of this information in prices does not exclusively depend on the trading efforts of these insiders.

Capital Asset Pricing Model (CAP) theory teaches us that a security represents only a particular combination of expected return and systematic risk. For every share/option there are many potential substitutes available. The price of a security changes as a result of new information that alters investors´ expectations about the security´s risk and return. These investors assume that insiders trade because private ('hidden') information has altered their (ie the insiders´s) expectations.[290] On the premise of the CAP, ie that all stocks are priced equally in efficient markets, and a perfect correlation between expected returns and market risk exists, investors can in fact be indifferent about holding any two securities with the same beta factor.[291] A beta factor is the portion of risk represented by the relationship between the riskiness of the market and the riskiness of a particular security[292]. Put differently, all stocks with the same beta factor are perfect substitutes - absent inside information[293] - which implies that the demand curve for any given stock is perfectly elastic over a very wide range.[294]

The consequence of this is that even a large increase in the supply of a particular security in the market has no observable effect on price.[295] Hence insider trading in itself cannot cause any damages to investors on the other side of the market. Insider profits do not even vary with the size of the trade, because the elasticity of the demand curve is not influenced by the size of the trade.[296] This is important when we discuss civil remedies against insider dealers. At least there can never be any damage caused by an

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289 Gilson and Kraakman at 572.

290 Gilson and Kraakman at 630.

291 Carney, idem at 884 et seq.

292 See Carney op cit at 884.

293 Carney, idem at 885; see also Manne op cit (Cato Journal) at 938.

294 Carney, idem at 885.

295 Scholes, 'The market for securities: Substitution versus price pressure and the effects of information on share prices', (1972) 45 Journal of Business 179 at 200-204; see also Manne op cit (Cato Journal) at 938.

296 Givoly and Palmon, 'Insider trading and the exploitation of inside information: Some empirical evidence', (1985) 58 Journal of Bus 69 at 79 et seq.

individual insider transaction. This is a strong confirmation of our findings when we considered harm allegedly caused by insider trading: there is indeed no material loss to the outsiders through an insider transaction.

c) How prices really react upon insider dealing

Price increases (ahead of positive information) or declines (ahead of negative information) are attributable to the information effect of secondary offerings, eg that insiders were selling out.[297] Their trades, however, (no matter how big the size of their transaction) do not result in a price change. The major implication of this is that an increase in the volume of transaction in any particular security has no impact on its price, unless traders believe that valuable new information about the issuer exists.[298] Investors can decode trade signals in order to aquire new data.

'Signal' in terms of market processes is information about trade volumes or identity of traders (ie insiders). Through such signals outsiders can decode the existence of inside information without knowing the information itself. The outsiders´ transactions will finally adjust the price. Thus, the reflection of non-public information in prices (ie before the information has been disclosed!) is a two-stage process: it is first triggered by initially-informed 'insider' trading; but then, at a critical threshold, it rapidly accelerates as a result of reactive trades (the so-called derivatively-informed trading). This ensures that prices reflect each 'bit' of decoded information with efficiency.[299] Stated differently, the process helps reflect particular key trading facts (price, volume and insider trading, if it is detected).

Such pieces of information have strong implications for price. Thus, as Estrada[300] points out, insider trading prohibition reduces the flow of inside information channelled into securities prices - and so magnifies the reaction of these prices produced by the public announcement of non-public information. That implies that such a prohibition makes securities more

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297 Scholes op cit at 200-204.

298 Carney op cit at 885. Although an increase in volume does not significantly change the price, larger trades may send stronger signals to uninformed investors, see Givoly/Palmon op cit at 79 et seq.

299 Gilson and Kraakman op cit at 578.

300 See Estrada, 'Insider trading: Regulation, deregulation, and taxation', SZW 1994, 209 at 211.

risky! Indeed, this is a very interesting finding, particularly with regard to the so-called conservative (small) investor who, according to legislation and the capital market people is said to need so much protection.

We learn from this that insiders do not cause price movements themselves, but send out certain signals which can be decoded by other traders who then cause price adjustments. This view has received considerable empirical support. Using previously unexplored data of the SEC, Meulbroek[301] finds that the stockmarket detects[302] the possibility of 'informed' trading and includes this information into the stock price. Both the amount traded by the insider and additional trade-specific characteristics lead to the market´s recognition of the informed trading. To the extent that insider trading reveals the presence of valuable information, it generally moves stock prices in the correct direction.[303]

Typically, however, the insider trader will find it desirable to ensure that the market price does not reveal his information (price signal). He will seek a situation where there is a 'pooling' equilibrium, rather than a situation with a 'separating' equilibrium where information can be decoded from prices.[304] This simply means that insider activity can be decoded more easily when surprising price movements (like sudden increases of bid-offer-spreads) occur; and that the insider prefers to hide in the 'pool' of all the stock orders. In a 'pooled' market products of different qualities are traded

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301 Meulbroek, 'An empirical analysis of illegal insider trading', (1992) 47 Journal of Finance at 1661-1699.

302 'Undetected' trading does practically not signal at all, cf Carney op cit at 887; there is empirical evidence that insiders make a major part of their stock market gains from information revealed through trades, cf Givoly/Palmon op cit at 79 et seq.; the contrary, ie that insiders hide their most important transaction-information by trading through friends or relatives (eg to avoid sanctions) is observed by Seyhun, 'Insiders´ profits and market efficiency', (1986) 16 Journal of Financial Economy 189 at 207.

303 Manne at 78 et seq. was once more the author who first raised this issue. Yet, the phenomenon is not caused by increased demand through insider orders, but through derivatively-informed trading, for more details see Carlton/ Fishel op cit at 879 et seq. and text hereinbefore.

304 Laffon and Maskin, 'The efficient market hypothesis and insider trading on the stock market', (1990) 98 Journal of Political Economy at 70-93.

at the same price. In the case of insider trading, all shares of one company are still the same, but some of the shares are traded while the trader has superior knowledge of the true value of the share - a similar situation to a market where different products are traded at the same price. Thus undetected insider trading creates such a 'pool' in which the insider can hide provided there is sufficient trading volume by other market participants.

The EMCH may well fail if there is imperfect competition on the market[305], because then there will be insufficient competitive activity amongst other traders. And sufficient competition is necessary to ensure that inside information is decoded and the price adjusted as quickly as possible.

Gilson and Kraakman [306] have pointed out that the (initial) distribution of information amongst traders will determine the relative efficiency of the market´s response. If competitors in the market do not possess sufficient skills to discover new information (and thus move the price in the correct direction), efficiency cannot be achieved. Hence the importance of financial intermediaries (ie a broad range of institutional investors, from banks and insurance companies to mutual funds[307]) whose task is to spread new data, and to encourage competition trading. It would therefore be unwise to deter professional traders who have access to information as soon as it is announced. This has important implications for the definition of 'non-public' ie that it is not in line with economic theory to give extra time to absorb the news after it has been publicly announced. It also follows from this economic finding that some market professionals have to be exempted from the insider trading prohibition. Efficiency depends on how quickly information is incorporated into prices, and these professionals help incorporating it.

d) How to strengthen the signal decoding and price adjustment process - special disclosure requirements for insiders?

Because derivatively-informed trading seems to function slowly and sometimes only sporadically, such trading does not seem to have much effect on price efficiency.[308] Therefore, interestingly enough, the critical

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305 Laffon and Maskin, idem at 92 et seq.

306 Op cit at 592 et seq.

307 See for this definition Smith op cit (Institutions and entrepreneurs) at 10

308 Gilson and Kraakman, idem at 630 et seq. - CAP theory teaches us that a security

policy question is not whether or not to permit insider trading, but whether the derivatively-informed trading mechanism can be made to operate more efficiently.[309] Only this would make the market more efficient - the aim of the proponents of insider trading prohibitions.

This again suggests that what is important is not so much insider trading prohibitions - so long as other measures are provided which ensure fast absorption of new information. One suggestion in this regard has been that insiders must disclose the fact of their trading and the size of their trades (not, however, the information itself). Yet, as such disclosure is required only some ten to forty days after the trade,[310] this would seem to do little assist to the efficient operation of the derivatively-informed trading.[311]

Gilson and Kraakman [312] suggest that, at some period before trading, the insider be required to disclose his identity and the size of the intended trade ('pre-trade' disclosure). This policy recommendation is not without objection. Above all, there is the problem of monitoring insider trading, detecting it, and, also, the (transaction) costs incurred by supervisory bodies (ie taxes would have to be imposed in order to pay these costs). What is more, it is not really desirable to oblige insiders to announce their trades in advance. Prices would then rise irrespective of whether he deals on inside information or not. Like everybody else the insider has personal price limits. If these limits are reached as a consequence of his announced intention to sell, will he nevertheless have to sell the shares because he had reported his intention? This cannot be the right approach. Moreover, the separation of ownership and control is intensified where insider are deterred from trading. Therefore, such disclosure requirements do not increase the efficiency of the market.

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represents only a particular combination of expected return and systematic risk, for which there is a vast number of substitutes. Thus, the relevant supply for purposes of determining the impact of insider trading is not the 'float' in the particular security, but rather the total of all other investment opportunities with a similar relationship between risk and return. The increase in the correctly specified supply caused by an insider's sell order is simply too small to have anything but a transitory, and probably insignificant, impact on the price of the security.

309 Gilson and Kraakman, idem at 631.

310 See s 16(a) SEA in the USA.

311 Gilson and Kraakman, idem at 632.

312 Idem at 632.

II. Clever outsiders; techniques of market makers to avoid losses to insiders; and allocative efficiency

We shall now consider certain techniques developed by investors which help to avoid 'losses' to insiders if there are such 'losses'. We shall see that investors can protect themselves, and also enhance market efficiency, without the need for legal prohibitions.

1. 'Clever' and 'naive' outsiders

Even if there are occasionally losses, investors generally have developed skills to protect themselves from losses to insiders. Today, only naive outsiders trade without taking into consideration that insider trading does occur. They are likely to lose if they do not take steps to prevent possible losses. Ex ante, as we have seen, in the case of insider prohibitions *all* outsiders can sometimes expect to gain and sometimes to lose.[313] Naive outsiders, however, will always 'lose', if there are losses.

'Sophisticated' outsiders discount any expected loss from the share price. They will pay a lower price for the stock when they purchase because they assume that some of the shares are offered by insiders (or demand a higher price when they sell, assuming that some shares are sold to insiders).

In case the shareholder is an outsider who paid a higher price for the shares (ie he has not discounted expected losses to insiders), he will ask for a higher dividend yield per share according to his earning expectations. In a subtle way, he claims back from the company the expected loss to insiders. For the shareholder both ways are effective to make up for expected losses to insiders.[314] In other words the market provides means by which investors

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313 Haddock and Macey op cit at 1454 explain why this is so: If insiders do not sell ahead of bad news, the price of the stock will be driven down less quickly. Thus selling outsiders who sell between the event and its announcement will be better off than in situations where insiders trade because they sell at a higher price. If insiders do not buy ahead of good news, selling outsiders are worse off because insider trading would have driven the price of the stock up and the outsiders would have obtained more for their shares.

314 Demsetz, 'Corporate control, insider trading, and rates of return', (1986) American Economic Review 313 at 316; see also Ott/Schäfer, 'Economic effects of EEC insider trading regulation applied to Germany', International Review of Law and

can effectively protect themselves. There is no need to ban insider trading, so long as it is beneficial, ie so long as its results in more accurate pricing, thus enhancing allocative efficiency.

2. Market makers

Some writers, above all in English economic literature,[315] argue that the main 'victim' (ie the most likely to suffer losses) of insider trading is the market maker.[316] This concern arises from the fact that trading on most anglo-american[317] stock exchanges is carried out by professional market makers, ie people who hold themselves out at all normal times in compliance with the rules of a regulated market as willing to acquire or dispose of securities[318]. Market makers are on this broad premise obliged to set prices. They must deal, and so he will inevitably lose to insiders.

This argument is, however, unconvincing. Clearly, the professional market maker is not a naive outsider. The market maker is fully-aware of the risk that insiders might cause losses to him. What is more, the market maker can

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Economics (1992) 357 at 363. The weakness of this argument is that as soon as the traded securities are commodity futures or other derivatives, the trader cannot demand a higher dividend. It is evident that the same applies to sellers of shares. On the other hand, we can certainly assume that a company which does not pay the highest possible dividend will not survive in a competitive market - allocational processes will direct capital to more profitable investment possibilities.

315 See in particular Fenn/McGuire/Prentice, 'Information Imbalances and the Securities Markets', in: Hopt/Wymeersch (eds), 'European insider dealing - Law and practice', London, Boston, 1991 at 5; but see, for a view which advocates decriminalisation of insider trading, Arshadi/ Eyssell, 'The law and finance of corporate insider trading: Theory and evidence', Dordrecht, 1993 at chapter 7.

316 Goodhart, 'The economics of Big Bang', (1987) Summer Midland Bank Review 6 at 9 et seq.; Alcock, 'Insider dealing - how did we get here?', 15 Comp Lawy 1994, 67 at 67; King/Roell, 'Insider Trading', (1988) Economic Policy 163 at 169.

317 Not so, however, in Germany, where they have an auction system which is based on the so-called 'Einheitskurs' being the price at which the highest number of transactions can be carried out. None of the brokers or dealers has the obligation to 'make' a price and deal.

318 Cf Sched 1, para 1(2)(a) to s 53(4) of the CJA 1993 Part V.

also benefit from such 'losses' to insiders[319]. The reason for this is that when the market maker knows that insiders are acting on one side of the market he can re-arrange his price quotes accordingly. The imminent risk of his position is that most of the time he will not know whether he deals with an outsider or an insider. Therefore, in order to recoup such losses, market makers must widen their bid/ask-spreads[320]), on the basis of which they deal with other investors,[321] irrespective of whether or not these other parties happen to be insiders.

The ultimate victims are, then, the ordinary investors who pay higher transaction charges for the gains of the insiders. Thus there seem to be real benefits that can be obtained through preventing insider dealing.[322] On this basis, in the eyes of most English legal writers, insider dealing should be prohibited.[323] But this is not really convincing.[324] The argument assumes that outsiders who are not market makers are naive. But, as we have seen in the previous subsection, outsiders have the necessary means to protect themselves against losses; and what is more, the risk of a loss is indeed very small (see chapter on 'loss'). Given the large number of financial services people, investment and trust bankers, financial intermediaries, fund managers, analysts, and other advisors who deal professionally in the markets (and assist the naive outsiders when they bargain for the 'good' prices), it is surely wrong to base legislation on the assumption of the naive outsider; and, as this naive outsider is always the ultimate victim, the argument that market makers suffer losses is also not convincing. Professional traders will ensure that the price structure is efficient and

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319 See King/Roell op cit at 169 who quotes a bookie as saying 'he (ie the insider) is my most valuable client. I always shorten the odds when he bets, it saves me a fortune.'

320 Schmidt, 'Insider regulation and economic theory', in: Hopt/ Wymeersch (eds) op cit 21 at 26.

321 Goodhart op cit at 10; and indeed, the study by Copeland/Galai, 'Information effects on the bid-ask spread', (1983) 38 Journal of Finance at 1457 gives evidence of a positive relation between insider trading and market makers´ spreads.

322 Goodhart, idem at 10.

323 McVea, 'Financial Conglomerates and Chinese Walls', Oxford, 1993 at 61; Rider/Ffrench, 'The regulation of insider trading', London, 1979 at 3.

324 See the German economist Schmidt, 'Börsenorganisation zum Schutze der Anleger', Tübingen, 1970 at 37-79.

'correct'. This is one of their important functions. It is more likely that all dealers are efficiently protected when market makers protect their interests.

3. Self-protection and allocative efficiency

On the premise that practically every insider either protects himself or is protected by the pool of trading, it seems certain that all outsiders will discount the expected losses to insiders from the share price. That has an important implication: it will lower the general price levels, in other words shares become cheaper. If prices on secondary markets are lowered, this is not without effect on the primary market (ie the issues of new securities): their prices will also be lower (remember that new shares must always be less expensive than those which are already traded - otherwise investors would not invest in them), with the result that less capital will be allocated to companies, and, consequently, less money will be invested. This argument is called the 'higher capital cost' approach.[325]

Moreover, the increased bid/ask-spread brings about a taxation-effect for the investors, which may result in a preference to invest in things other than

325 Ott/Schäfer op cit at 364 et seq.; the approach is based on the fact that rational investors can choose from a variety of financial instruments, not all traded on securities markets, see Easterbrook, 'Managers´ discretion and investors´ welfare: Theories and evidence', (1984) 9 Delaware Journal of Corporate Law 540; see also in favour of this view King/Roell op cit at 170; but see against this view Schörner op cit at 110 et seq.; the weakness of this argument is that, if insider trading truly damages stock value, we would expect to see firms interested in reducing the cost of capital by adopting their own rules against insider trading. There is, however, no evidence that firms do adopt such rules, Carney op cit at 896. See, however, the examination on the (positive) interrelation between such rules and the share price of financial institutes by Torabzadeh/Davidson/Assar, 'The effect of the recent insider-trading scandal on stock prices of securities firms', (1989) 8 Journal of Business Ethics at 299 et seq., whose overall findings furnish evidence that investors appreciate the fact that a firm has internal compliance codes. See for an examination of such codes Tippach op cit at 212 et seq. See also Manove, 'The harm from insider trading and informed speculation', (1989) 104 Quarterly Journ of Econ at 823-845, who says that insiders are able to appropriate returns to corporate investment at the expense of shareholders. Insider trading therefore tends to discourage corporate investment and reduce the efficiency of corporate behaviour.

shares (or options), so that capitalisation will not be optimal.[326] This would be an indirect harm caused by insiders, even though it is not caused by their trades but by their mere presence in the market. Such a lowered allocative efficiency could finally cause more severe harm to market and society than insider trading itself was ever thought to cause.

Is this approach convincing, and must insider trading therefore be banned? The answer is again: no. Firstly, the above argument can be countered by pointing to the fact that insider trading helps incorporate new data into share prices. Hence both prohibition (on the basis of the higher capital cost-approach), and deregulation (ie free insider trading) aim at the same beneficial result for the market. It is impossible to determine which is the more suitable approach. They merely suggest two different options.

Secondly, whenever investors trade, there is uncertainty about information which has not yet been released. Insiders abstain from trading because they are not allowed to disclose the information to the public at large.[327] Hence all other investors are still uninformed, and uncertainty prevails. In this case, the inaccuracy of the price is even worse than in a situation where insiders trade,[328] because insider trading will incorporate information into prices.[329] Once the new information is released, the price reaction could be less drastic in situations where insider dealing has occurred previously.[330]

Whether insider dealing is prohibited or not, the only way to avoid losses resulting from a lack of information is to trade great volumes of several shares. Such trading minimises losses due to informational imbalances. This

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326 See Schörner op cit at 160.

327 See Brudney, 'Insiders, Outsiders and Informational Advantages under the Federal Securities Laws', 1979 (93) Harvard Law Review at 338.

328 See Manne op cit at 155-159. This hypothesis seems to be almost generally accepted today.

329 See Schörner op cit at 162 et seq.

330 See for this view R. Schmidt, 'Aktienkursprognose', at 359 et seq.; see also Carlton/Fishel op cit at 866; but for a contrary view see Deryl/Peterson, 'Insider trading revisited', (1991) Journal of Business Ethics 57 at 58 et seq., who think that the price change remains the same even if insiders trade. With respect, they seems to overlook modern findings about derivatively informed tradings. If their view were correct, it would be pointless to prohibit insider trading. Actually, whether or not insider trading occurs would have absolutely no effects on capital markets at all.

is the case both in markets where insider dealing is prohibited, and in markets where it is allowed.[331] The small investor will have to incur some losses anyway, whether or not insider dealing is prohibited because he, by definition, does not have large funds to increase his trade volume in order to minimise his losses. To do this, one would need sufficient capital.

4. Conclusion

There is an important lesson to be learnt from this subsection. The persons who really profit from the insider trading prohibition (based, of course, on the premise that it is obeyed) are market participants who have enough capital to invest. These traders are mainly institutional investors, such as funds, banks or brokers.[332] There are no actual benefits for the (allegedly protected) small investor through insider dealing prohibition. The fact is that certain groups have special interests that are promoted by imposing prohibitions on insider trading. The capital market is an important factor in our modern societies; and surely the legislators listen to these groups because of their economic power. Sometimes they may listen too carefully.

Our analysis has shown that one is not compelled to conclude that insider trading causes harm to investors. Nevertheless, even if there is no need for prohibition, we must still ask ourselves what alternative we can offer. An alternative must be moulded in such a way that a sufficient number of investors will feel protected, and more so than under a regime of insider prohibition. It has also become clear that prohibition (ie regulation) is probably not the best approach; at least, it is not the only possible way to address the problem of insider dealing. It seems that such protection would, at least to the same extent, be provided by an agency model (ie a non-regulation model based on contractual freedom) which will be discussed in the following subsection.

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331 Schörner op cit at 163.

332 See Manne op cit (Cato Journal) at 942 et seq.

B. The agency approach in the context of market processes

In Chapter II we saw that one of the main problems posed by the agency analysis is that of 'moral hazard' (other problems like adverse selection have been dealt with). 'Moral hazard' was used as a term to describe the possibility of the agent increasing his own utility to the detriment of the principal´s. We saw that, to overcome this problem, the firm will need either specific control systems or special salary agreements. If the company does not wish to rely on state help, the managerial contract must include agreements on incentives, risk-sharing, participation in the stock capital, or - as we will see -possible cuts in salary in return for allowing the manager to deal as an insider[333].

I. Interest groups versus shareholder interests

It has been suggested that potential purchasers of a company´s shares, whether outsider-shareholders or complete outsiders (potentially buying shares of the company for the first time), might want insiders to trade. Why? If a price sensitive event comes to the attention of the firm´s manager before anyone else learns of it, the manager will profit if he can trade on the basis of this knowledge. The manager will not profit if such insider trading is effectively prohibited by law. The key question then becomes: who gains that benefit when insiders cannot.[334] We have to remember that both insiders and market professionals can be identified as interest groups[335] in regard to these extra gains.

We must bear in mind that whoever it is who gains, it will definitely not be the outsider shareholder, ie whether insiders are banned or not, the outsider shareholders will lose the trading profit anyway. The reason for this is that if insiders do not trade, then the persons who will gain will be those who are able to hear the news first after the announcement: market professionals, such as brokers, exchange specialists, arbitrageurs, brokers, portfolio managers, securities researchers, and financial analysts.[336] If insiders trade, they will capitalise on the firm´s good fortune; if they do not

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333 Carlton/Fischel op cit at 866 et seq.; Haddock/Macey at 1449 et seq.

334 Haddock/Macey at 1458.

335 Haddock/Macey at 1463

336 Haddock/Macey at 1459.

trade, the next (second-best) information processors will. The 'normal' capitalist shareholders will not benefit if insiders are barred from such trades, because other outsiders can beat them to the information. The only difference lies in the identity of the parties to whom the trading profits go, insiders or market professionals.[337]

II. Conflict of interest: shareholders and managers

Shareholders could be, however, at least partial beneficiaries when insiders trade on inside information. It is important to recognise that there are mutual incentives for allocating the property rights in information to its highest-valuing user, and that this does not depend on negotiations between insiders and investors.[338] In the agency context, the relevant parties are insiders and shareholders who are involved in a private contract. Since Demsetz and Jensen the corporation as such is considered as a 'nexus of contracts.[339] The pre-existing contractual relationship manifests itself in the company´s articles of incorporation.[340] That contract ties the shareholder (owner) as principal and the manager (insider) as agent. The basic problem of such agency structures is how the principal can reap the greatest

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337 Haddock/Macey op cit at 1463; see also Haddock/Macey, 'Regulation on demand: A private interest model, with an application to insider trading regulation', (1987) 30 Journal of Law and Economy 311 at 314, who assert that insiders gain less from trading on information which they have generated themselves than professional market participants, idem at 338. This view originates with Manne op cit (Cato Journal) at 942 - and, more generally, with Stigler, 'The theory of economic regulation', (1971) 2 Bell Journal of Econoniy and Management Science at 3.

338 Carlton/Fischel op cit at 863.

339 See Demsetz (Structure of ownership) and Jensen/Meckling (Managerial behavior). For a modern comment on their views see Landauer, 'Beyond the law and economics style: advancing corporate law in an era of downsizing', (84) Calif Law Rev 1996, 1693 at 1701, quoting Butler, 11 Geo. Mason L Rev, according to who even state corporations could be modified by mutual agreement.

340 Haddock/Macey op cit at 1449 fn 1; the contractual approach to corporate responsibility is, historically, a liberal response to the policy criticism of managerial capitalism following the separation of management and ownership in modern corporations, see Kaen/Kaufmann/Zacharias, 'American political values and agency theory: A perspective', (1988) 7 Journ of Bus Ethics 805 at 813 et seq.

advantage through incentives that influence the agent´s behaviour, yet reward the agent enough so that he will not quit.[341]

One of the principles of an agency relationship is that any changes in the rules of the game will either benefit or hurt all the players. Clearly, by allowing their managers to trade on inside information, companies grant them, and not the shareholders, the benefits from the information. So we must ask why firms might want to allocate the property right in valuable information to their managers rather than to their shareholders. After all, the company is based on the shareholders´ capital. Hence the question is: why should shareholders want to allocate property rights in valuable information to managers rather than to themselves? The answer is that the shareholders will benefit from insider trading because they will allow the insiders to trade only in exchange for a reduction in their wages.[342]

It is important to understand that principal-agent-relations are contracts. In terms of these contracts managers can profit from altered expectations about the firm (as a compensation package) and shareholders will be compensated by the manager´ cut in salary. This will help to realign the interests of principal and agent: agents would be allowed to increase their profits on the strength of inside information, shareholders will increase their returns because expenses are reduced.

III. Moral hazard and control markets

The idea that insider trading can be regulated by contract so as to benefit both the shareholders and the managers is conceptually brilliant. Yet, as we have seen, it has raised criticism.[343] As a matter of fact, insiders can also

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341 Pratt/Zeckhauser, 'Principals and agents: An overview', in Pratt/Zeckhauser op cit 1 at 17. It is assumed that firms are not dominated by managers, and that shareholders are not systematically robbed of their invested wealth, see Haddock/Macey op cit at 1450 fn 1; the terminology may cause some problems for lawyers: although lawyers use the agency concept in a variety of senses, the legal concept implies a relationship in which the principal retains the power to control. In firms this can be different, see Clark, 'Agency costs versus fiduciary duties', in Zeck/Pratthauser op cit at 56.

342 Carlton/Fischel at 861; Haddock/Macey at 1451; Demsetz, 'The structure of ownership', (1983) 26 J of Law and Econ 375 at 379; Easterbrook op cit at 83.

343 Easterbrook op cit at 81; also Easterbrook op cit (Secret agents) at 309.

profit from trading ahead of bad information.[344] In the extreme case this could make managers indifferent as between working to make the firm prosperous, and working to make it bankrupt.[345] One objection to Manne's position was that managerial staff will be distracted from diligent work when they trade.

Managers might also be tempted to use such negative information. That, however, would create incentives to produce such negative data.[346] From this perspective the insider would not only gain from negative performance, but he would consciously perform poorly in order to profit from the bad news about his firm. As we have seen, Manne's answer to this problem was certainly not entirely satisfactory. Without the existence of some specific control markets managers would in fact be able to exploit the agency relation to the detriment of the shareholders.

1. Control markets for managers

There are three control markets which make it extremely difficult, if not impossible, for the manager to act to the detriment of the shareholders: the capital market; the labour market for managers; and the market for take-overs.[347]

The first and perhaps most obvious of these control markets is the capital market. As soon as managers act contrary to shareholders' interests, share

344 Easterbrook op cit note 15 at 84.

345 Carlton/Fischel op cit at 873; see Schneider op cit at 1430.

346 Gilson and Kraakman op cit at 633 fn 221, therefore, made the point that, if insider bans are lifted, managers should at least be forbidden to exploit negative information. It is respectfully submitted that this does not contribute to an appropriate solution of our problem. Above all, the monitoring institutions (and hence the problem of costs) would have to continue operating in order to detect trading on negative data. This would not help to increase social welfare. Secondly, it is a fact that some firms perform poorly. Assuming that insider trading helps to reflect this in the share price, then this is still better for all investors. Therefore, it is wiser than rely on prohibition and thereby postponing the reflection of such bad news in prices.

347 See Jensen, 'Agency costs of free cash flow, corporate finance, and takeovers', 76 (1986) The American Economic Review, Papers and Proceedings 323 at 324 et seq.

prices will drop.[348] Such a drop disciplines managers for various reasons. Firstly, it will be more difficult to raise capital funds for projects which makes it likely that some managerial staff is dismissed. Secondly, in many managerial contracts there are clauses which grant the manager a bonus (shares or options), or a participation in the dividend if the share price remains above a certain level - as soon as the price drops below this level, the manager will loose the bonus. His interest is then also that the company performs well.

The second of these markets is the managerial labour market. The basic idea here is that both good and bad managerial performance is reflected in the market value (ie the totality of the share prices) of the company; and bad results lead to cuts in salaries, or even to dismissals. Thus managers have a strong incentive to refrain from both consumption on the job (ie pursuing their own interests more than the company´s)[349] and from shirking (ie lowering their work efforts).

It is however not so easy to measure the quality of managerial performance. Because of asymmetric information (which is inherent in agency relations), the shareholder does not always know whether the company´s bad performance was due to a manager´s faults or to reasons exogenous to the company (which cannot be attributed to managers). Yet many enterprises today are highly diversified, so that exogenous influences, as difficulties at a particular branch, are not of great importance. Thus, it is much easier for the stockholder to tell whether the management of a conglomerate is doing a good or a bad job than it is for him to tell the same about the management of an individual branch or small company. Tullock[350] said that, simply following the rule of firing the management whenever the profits fall may well be an optimal technique for operating the company.

Clearly, this is an uncompromising view. Yet together with the share market, this seems to be an efficient control, because (as we have seen) the insider/manager who trades brings the share price in line with the 'true value'. Hence, as soon as insiders who have performed their managerial

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348 See Manne, 'Mergers and the market for corporate control', 73 (1965) Journal of Political Economy 110 at 112 et seq.

349 Manne op cit (Mergers) at 112; Jensen/Meckling op cit at 316-8.

350 Tullock, 'The new theory of corporations', in Streissler (ed) 'Roads to freedom', London, 1969 at 307.

duties poorly start selling their shares, the share price will drop. That drop is observable to the stockholder, and can thus be used as a parameter to distinguish between managerial faults and exogenous influences. The latter can hit the whole branch of the industry so that share prices decline in the whole branch. In the absence of such exogenous influences (eg political news) the shareholders know that the drop in the share price is due to poor management performance.

The third control market for managers is the market for enterprise control (eg buy-outs or take-overs). Enterprise control is the property right to determine the management of corporate resources, ie the right to hire, fire and set the compensation of, top-level managers.[351] This control function is itself a value for the (controlling) shareholder.[352] The idea of control is this[353]: if the share price of a company is lower than the average share price of firms in the same field of economic activity, or lower than the market on the whole, this is an indicator of bad managerial performance. Such companies offer possibilities for capitalist shareholders, the so-called 'raiders' to gain profits from firing the management and hiring new labour who will better serve the interests of the shareholders. That will thus result in an increase of the share price, hence a profitable resell for the investor.

The most common way to 'raid' is by carrying out management buy-outs or a take-over by another company. It has been said that a manager who fears losing his job (through such replacement or a take-over, in other words, through an external or internal control market for managers), has an incentive to trade on inside information hoping that the take-over will fall through.[354] But this is a weak argument, because (as we assumed) the information is negative. Hence, selling ahead of that news will help lower the share price even further and thus facilitate the take-over. Therefore, the management will rather try and perform well in order to maintain their career positions. Again here the reflection of their good performance is the rise of the share price which will make it undesirable for investors to take-over company. The market for corporate control is best viewed as an arena

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351 Jensen/Tuback, 'The market for corporate control', 11 (1983) Journal of Financial Economics 5 at 5.

352 Manne op cit (Mergers) at 112.

353 Manne, idem at 112-4.

354 Easterbrook op cit at 333 et seq.; see also Davidson/Solomon at 92.

in which managerial teams compete for the rights to manage corporate resources.[355] Both the control market for managerial labour and the market for enterprise control are complementary to one another.

2. Codes of Conduct

Bearing in mind the original concept of the theory of the firm, it is clear that there is no ambiguity about the objective function of the firm in modern financial theory: managers should maximise the current market value of the firm.[356] Thus, it is sensible (instead of chasing insiders) to develop certain ethical codes of conduct within firms which, again contractually, bind the managerial staff. Managerial skills should include the formation of a specific business ethic. When this is done, staff in leading positions are likely to gain satisfaction from their company´s well-being. Moreover, empirical studies[357] have shown that share prices increase when firms implement business strategies based on ethical codes of conduct.[358]

Therefore, it appears to be wiser to carry out one´s business in a moral way than to waste much thought on insider trading. However, we are not sure of all this. In order to prevent the small likelihood of excessive misuse (or production) of negative information, it seems to be a good approach to prohibit short sales effected by managers and directors.[359]

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355 Jensen/Ruback op cit at 5 et seq.

356 Kaen et al op cit at 815 (quoting Jensen/Smith).

357 Torabzadeh/Davidson/Assar, 'The effect of the recent insider-trading scandal', 8 (1989) Journal of Business Ethics 299 at 302 et seq.

358 See Tippach op cit at 222 et seq.

359 Carlton/Fischel op cit at 893; see Schneider op cit at 1434 et seq., who suggests that dealing on 'put options' by insiders should be prohibited, idem at 1435. This is questionable. Contrary to short sells which do not, normally, exceed a period of a few days (which means that the information must already be about to be released in order for the insider to gain a profit), 'put options' can cover periods of several months. Why, however, should this be prohibited then? If the market is efficient, dealing in options will also help reflect complete information. Such dealings also convey information; and this is beneficial because it contributes to efficient pricing.

IV. More than a zero sum game: advantages of agency relations which allow insiders to trade

There are several reasons why such contractual agreements are more economically efficient than attempts to prohibit and monitor insider trading through administrative bodies.

The first of these reasons relates to the informational effects that such managerial contracts allowing insider trading can have on the markets. We have seen that it is generally assumed that insider trading brings the share price in line with the informational 'truth' (true value). The more accurately prices reflect all information (ie including inside information), the better the prices will guide capital investment in the economy (allocative efficiency).[360]

Secondly, disclosure costs are lowered through insider trading within a contractual frame. It will be recalled that the (initial) distribution of information will enhance price efficiency. Hence it is in the interests of firms to disclose information about themselves. Disclosure, however, is expensive.[361] And complete (mandatory) disclosure can never be an optimal solution, because, for instance, in the case of a confidential study revealing valuable mineral ore deposits,[362] such full disclosure would destroy incentives to create valuable new information. That destructive impact on incentives is inevitable with full disclosure because all information will then be treated as a public good, ie something free of cost.[363] For this reason shareholders may also value insider trading because

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360 Carlton/Fischel at 866.

361 Inside information particularly is extremely costly to everyone except the insiders, cf Gilson and Kraakman op cit at 628.

362 Carlton/Fischel, idem at 867 et seq.; Easterbrook/Fischel, 'Mandatory disclosure and the protection of investors', (1984) 70 Virginia Law Review 669 at 674.

363 It would be interesting to reconsider the nature of information, ie whether it is 'public' or 'private', in the light of this incentive argument. If firms are allowed to opt out of the regulation which imposes restrictions on insider dealing, information may become at the same time private and public: the insider exploiting it in a private context which is based on his contract with the shareholders; and, at the same time, public in that it enhances efficient pricing and allocative functions. Arrow, 'Limited knowledge and economic analysis', (1974) 64 American Economic Review 1,

it gives the firm an additional method of communicating and controlling information,[364] thus enhancing an optimal pricing of their stock.

Thirdly, the company´s internal communication systems should benefit from insider trading. Since higher-positioned managers want to make sure that they can trade as soon as information is produced, they will ensure closer contact with the other staff members who work, for instance, on a new product. A better internal communication will certainly help to improve the performance of the company.[365] Moreover, markets for managerial services and corporate control appear to function more effectively when insiders trade, because the true value of the stock is reflected in the price.[366]

Only superior managers will accept the compensation scheme, because they produce valuable information which they can exploit. This will help minimise the costs of screening (potential) managers.[367] That again brings about an advantage for the shareholders as the costs for their company are reduced. Hence the shareholders´ interest to refrain from exploiting inside information themselves, and to transfer this property right to the management.

Costs are also reduced for the State (ie the taxpayer[368] - also shareholders),

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argues, however, that information is a always a public good

364 This was a point made by Kitch, 'The law and economics of rights in valuable information', (1980) 9 Journal of Legal Studies at 683; Carlton/Fischel, idem at 868; another very interesting point in terms of market efficiency was made by Fischel/Ross: insider´s purchases, once disclosed or decoded, may be the reason that market participants become more optimistic, see Fischel/Ross, 'Should the law prohibit 'manipulation' in financial markets?', (1991) 105 Harvard Law Review 503 at 524. One would have to ask whether decoded selling would lead to a more pessimistic market. Even such pessimism reflects the situation in the market better.

365 Cf Easterbrook op cit (Agency) at 85.

366 Carlton/Fischel at 867.

367 Carlton/Fischel at 871 et seq.

368 Estrada op cit at 215 et seq. argues that insiders should be allowed to trade against the payment of a lump-sum tax. With this tax he suggests to compensate investors who are harmed by insider trading, idem at 215. This view is unacceptable, because, as we have seen, it is impossible to determine who is eventually harmed, if at all anyone *is* harmed. Taxation must therefore be the wrong device. The redistribution scheme which taxes create is also off track, because the first to profit from the tax-

because there will be no further need to monitor insider activities. And even if some monitoring of managers is still necessary on the part of firms, these costs will by far be lower than the enforcement costs of administrative supervisory bodies (whose success in barring insider trading is traditionally rather poor).

Earlier in this text the risk-problem was discussed. The objection here is that insiders might be tempted to invest in riskier projects. This argument is not convincing because, should the riskier projects fail, the manager will suffer a loss in the value of his human capital, because he is blamed for the failure.[369] Managers sometimes behave like administrative people and do not foster a constructive development. This type of manager should be encouraged to engage in riskier projects rather than deterred from insider trading.

As to the argument that information may be delayed because the insider wants to profit from it first, it has to be noted that there is no empirical evidence to support this fear.[370] On the contrary, it is more likely that disclosure will be made more quickly. Disclosure provisions fall within the ambit of responsibilities of the legislature, which must be designed so as to maintain sufficient incentives for the production of information. One such incentive is non-regulation.

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369 Carlton/Fischel op cit at 872.

370 Dooley, 'Enforcements of insider trading restrictions', (1980) 66 Virginia Law Review 1 at 34 who finds, after examining a sufficient number of cases, that insider trading did not delay the public disclosure of information.

C. Conclusion: a democratic approach to insider dealing

We have considered the economic theories; and their application to insider trading; the market process oriented approaches; and the alternative of agency, ie allowing insider dealing and using it as a form of compensation. It is now time to develop an onceptual approach which is a suitable basis for a proper legal solution to insider trading. This theoretical framework is also necessary in order to compare and evaluate the different laws.

I. Market protection

We have seen that there is neither empirical nor theoretical evidence to show that the individual investor needs protection. Thus, clearly the market is at the core of our concern. The aim of both prohibition and permission of insider trading by special agency contracts is the protection of the capital market. However, one is not sure about the best way to provide for this protection.

Efficiency concerns, transaction costs, and incentives are three of the major issues of market protection. We have seen that it is very dangerous to rely exclusively on the financial service people who argue that legal prohibition of insider trading is necessary in order to enhance market efficiency. The interest analysis has clearly shown that regulation serves their interests best; and that is why they try to convince the legislator to provide for prohibition. Nevertheless, there is also not enough evidence to prove that using a compensation package - in the sense that the insider may deal on the strength of (exclusively) positive information - is sufficient. It may as well be that for certain firms or insiders, depending on whether or not they are risk averse (and hence unwilling to give up a higher fixed salary) it is better to place a contractual or statutory ban on insider trading.[371]

There is no one single 'first best' solution. Given the overall economic impossibility of a first best solution in general, this is not surprising. This makes it necessary to find an approach which will help to ensure the efficient functioning of our markets until a convincing economic, and thus juristic, answer to the insider problem is found. In the meantime, our solution will have to be based on trial and error, and must be compatible with our democratic system.

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371 Haddock/Macey op cit at 1467 et seq.

II. The democratic approach

Two very important groups concerned with market protection have never properly been asked to offer their opinions: shareholders and companies. In our modern democracy it would seem vital to foster self-responsibility. So why not allow these interest groups to decide for themselves? One could certainly rely on their ability to pursue their interests. If they felt that a statutory system would be the best solution for them, they could opt in and have their shares monitored for insider activities. On the other hand, if they felt that they could save (transaction) costs and thus improve their performance, they could opt out and allow insiders to trade. To put it in a nutshell: less State where less State is wanted. And the State has to learn that citizens need no costly protection where markets function properly.

Although it is constantly asserted that markets must be protected, people ignore the fact that the market (within its own process) develops certain 'cleansing' mechanisms. We have seen that catch-words like 'market protection' (as used, for instance, by the European Directive on insider trading) are not yet well-founded, even though they are mentioned so often. It will be argued that, in most cases, legislators do not even state the hypotheses which legal enactments are based upon.

As long as we do not know with any certainty what is the best for the market, we should offer the greatest number of options, and let the market itself find out the optimal procedures. The market is composed of companies and shareholders. Financial analysts are of importance, but their importance is a secondary one. No doubt, in the course of time the best solution will be found. In the meantime we shall have to wait and see. The present legislation, however, provides only for prohibition. The costs for enforcement of this legislation are not fully revealed. Most investors take it for granted that taxes are used to pay the monitoring system. The allegedly beneficial effects of prohibition do not come free. Shareholders and companies ought to become aware of this. That should make them much more interested in non-regulation than they presently are.

There is also not enough evidence that statutory prohibition of insider trading is completely superfluous - as proponents of free market patterns believe. For instance, it could be detrimental to the markets to allow insiders to trade on the strength of negative information. Yet this issue can also be addressed via the contractual agency approach. Carlton and Fischel[372] argue that companies should be given the freedom to opt out of the regulatory system, which system ought, however, in the meantime to be maintained. Then we will be able to really compare the results, ie how investors react to the agency approach, and how companies perform without their insiders being prohibited from trading.

Some transaction costs have to be incurred, for managers will presumably accept cuts in salary only if these cuts are made up for by their expected profits from insider trading. In fact, the profits from insider dealing must be a little bit higher.

On the other hand, if insider trading is allowed, it is likely that managers will own more of their company's shares, which will serve two purposes. Firstly, it will diminish the separation of ownership and control. This is a very important issue: Georg Koffler, chairman of Pro 7 (a German TV Channel exercising a lot of media influence), for instance, said that he sold his 3% stake in shares of Pro 7, not because he thinks this is a bad investment, but because he would always be concerned about insider dealing.[373] This is certainly not a good development. Secondly, it will reduce the moral hazard risk (ie the incentive to generate negative information),[374] for managers would suffer losses from a devaluation of their own shares.

We can define the democratic approach to market protection as the conviction of the majority that something (ie either regulation or non-regulation) protects their interests best. This is democracy. We live with uncertainty; and we can never know anything with absolute certainty. By applying economic models to the reality of stock markets we will be able to lower uncertainty (which is reflected by heterogenous expectations) to a certain degree.

But what is theoretically best for individuals and markets is of less importance. As long as people think that they are protected by one or other model, then for them that model is a good model, and they will eventually

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372 Op cit at 895; Haddock/Macey op cit at 1468; this opinion is shared in the German economic literature by Schmidt op cit at 38.

373 Interview on TV (Channel SAT 1, 'Teleböorse'), 17.1.1996.

374 Schörner at 210.

choose it. The difficulty of all regulatory attempts is that they do not clearly reveal the hypotheses on which they are based. The suggested 'democratic approach' is honest and modest: its hypothesis is that we do not know whether regulation or non-regulation of insider trading is better. Therefore, it seems to be appropriate to leave both alternatives open to market participants.

III. Minimum standards of this approach

In this subsection both parts of the democratic approach will be explained. It is convenient to start with the prohibition, since this is the more common part of this model.

1. Opting in: insider trading prohibited

Firstly, companies can opt in and have their shares/options monitored. This alternative is chosen by companies which want to prevent their insiders from trading. Reasons for this choice could be: low variability of the share price, and risk aversion of either shareholders or managers. These companies must register with a supervisory body which monitors the tradings on the stock exchange. According to the amount of shares traded, the company will have to pay a fixed price for the monitoring service.

a) Who monitors? Who pays?

It is generally agreed that companies do not themselves have effective means to monitor insider activities on stock markets. Therefore, this task has to be carried out by a supervisory (State) body. Until now, the companies received the alleged benefits of this service without having to pay for it. That is not so in the democratic approach, which relies more on self-responsibility. If companies wish their shares to be monitored for insider dealing transactions they ought to pay for that service. The taxpayer should not be asked to pay in order to improve the performance of specific companies, if he is not interested in shares at all. Therefore, shareholders ought to pay via their firms.[375] The amount to be paid decreases the profits

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375 In this regard it has been a very meaningful step in the right direction that under the new German § 11 (1) Nr. 3 WpHG (for the WpHG see details hereinafter Part II) companies with registered securities must pay 10% of the costs for the

of the firm. That is the price to be paid for the alleged benefits of regulation.

The exact amount to be paid by firms ought to depend on the following variables: the volatility of the share price (because the higher the variability, the more likely insider trading will be); the average amount of shares traded per day; and, last but not least, the expected costs of the supervisory body (staff, equipment, and building). The fact that shareholders have to pay for what they have defined as their 'protection' will also make them aware of some advantages of the opting-out possibility. This approach makes it clear that monitoring insider trading is a special (and costly) service. If insider dealing were proved to be detrimental to the performance of the capital market, it would be advisable to use the general tax yield to have shares monitored, because then it would be in the common interest to enforce the ban on insiders. It is of course assumed here that, in a democratic society, capital markets serve the interest of all people, not only those of shareholders.

b) Clear-cut definitions ensure personal freedom

The economic theory which put forward the 'freedom approach' taught us that definitions of the 'insider' and of what constitutes inside information must be clear, to make it obvious to the insider to what extent his market activities fall within the ambit of prohibition. Otherwise deterrence would lower the liquidity[376] of the market, because the insider would choose not to trade even if he were allowed to do so. Clearly, any prohibition which is placed on insiders by the 'democratic approach' must respect this aspect of personal freedom of market participants. Also, the 'democratic approach' must take into consideration the economic doubts as to whether or not insider trading is harmful. One must be very careful not to fine insiders (or even imprison them) when it cannot be proved that they cause harm.

Although it is clear that company insiders (and information about corporations) must be encompassed by the legal definition of the 'insider',

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Bundesaufsichtsamt für den Wertpapierhandel (ie the supervisory body newly created for capital market matters.

376 This is an important issue for the JStE, since it is a developing market, see Roy Andersen (President of the JSE) in FAZ 8.11.1995.

this is less clear for market insiders (and market information[377]). Are they to be included in an agency model? At first sight, it would seem that the agency approach cannot cover market information, because this data is exogenous to companies and therefore uncapable of being included in firm contracts. Yet such market information can be included by the agency approach. Companies can decide whether or not they want their shares to be monitored. That decision, however, can cover market information as well, because this type of information is also incorporated into the price of securities. Companies may have a legitimate interest in achieving an even more accurate pricing of their shares through incorporation of market data. If so, they will allow their managers to trade. Companies may, however, be interested to ensure that only their managers can trade on market information, and not third parties (eg financial analysts).

Another issue must be addressed. So far we have discussed only 'real' insiders. Normally, regulation encompasses tipees (it is suggested that their transactions be called 'derivative' insider trading rather than using the expression 'tipees'). They are of importance also for agency contracts, although they are not the managers of the firm. Their derivative insider trading enhances market efficiency because it helps incorporate new information into the share price. They are not supposed to enter into contractual relationships between insider-managers and firms or shareholders, but managers might wish to sell their information to them.

If so, we need a contractual clause in the managerial contract permitting the manager to sell the information to third parties. This would be beneficial for the market because the manager (or entrepreneur) does not always have enough capital to buy shares. However, if one wishes to ban insider trading (contractually), it will be necessary to prohibit the manager from profitting by selling information because derivative insider trading is likely to affect outsiders as much as insider trading itself.

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377 For an interpretation of the term see Fleischer/Mundheim/Murphy, 'An initial inquiry into the responsibility to disclose market information', (1973) 121 University of Pennsylvania Law Review 798 at 799 et seq.; also Barry, 'The economics of outside information and rule 10b-5', (1981) 129 Univ of Pennsylvania L Rev 1307.

2. Insider trading allowed; pareto-improvements; incentives for managers; and first or second best contracts between firm and managers

The democratic approach does not only offer a prohibition-solution to insider trading, but also provides for firms to decide whether or not insiders can trade. Where firms allow (managarial) insiders to trade, profits from such insider trading would constitute a part of their compensation package.

a) Insider trading allowed

The second alternative in the 'democratic' model is that companies are free to opt out of the monitoring system offered by supervisory bodies. These companies do not wish their shares to be monitored for insider activities, because they feel that their performance is better when they reduce costs (for salary) and gain through the extra incentives given to managers to produce good information. Therefore, they allow their management to deal on the strength of inside information. Once firms opt out they will want to ensure, however, that most of the beneficial effects of insider trading (other than for the market functions) are passed on to the shareholders. They need to enter into a contract with the managers in which it is agreed upon that the insider accepts a cut in salary in return for the possibility to profit from insider trading.

b) Pareto improvement through firm contracts

The contract solution brings about a pareto improvement for all parties. For the shareholder there is more accurate pricing and more incentives offered to the manager to generate good news. The managers can increase their compensation package by producing good news, which will in return increase profits for the shareholder. This aligns interests of shareholders and management.

Transaction costs for the firms are at the same time lowered, because information will be incorporated in share prices through insider trading, and does not need to be communicated (information costs) to every single shareholder.[378] The manager will have to bear more risk (ie risk share

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378 See Schörner at 216.

incentive to overcome the separation of ownership and control), even if he does not engage in riskier projects, because his salary depends on the performance of the company. This will also help overcome the separation of ownership and control.

A first-best solution (in terms of pareto-improvement) would be possible only if incentive problems were absent.[379] A difficulty that goes together with incentives is how to control the managerial work. The reality is that the principal/shareholder has no effective way of observing the work of the agent/manger.[380] Hence the need to include incentives in the contract at the risk of incomplete risk distribution. Risk distribution would be perfect only if the bargain was solely concerned with the question of risk distribution. A contract, however, which only includes risk distribution would potentially be to the detriment of the shareholder because of the unsolved moral hazard problem.[381] Therefore, it seems inevitable that the manager must be given some extra compensation[382] (in order to secure the risk of moral hazard). This will immediately result in a second-best solution.

Nevertheless, the pareto improvement of this model is still more preferable to a model where insider trading is completely banned, because in the latter case monitoring and enforcement costs are excessively higher. Other forms of compensation (such as shares or options on shares) do not have the same effect: when the company performs badly, the manager´s shares lose value and cannot be sold, for that would imply a contravention of the insider trading prohibition.

c) The problem of dominant and controlling shareholders

A special situation can be observed in firms with a dominant shareholder. As a consequence of his dominant position he will inevitably gain access to inside information. The problem of his extra profits from insider transactions is that they could well be to the detriment of the average

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379 Schörner at 219 et seq, 225, rejects the first best solution in this context as a nirvana approach.

380 See Holmström, 'Moral hazard and observability', 10 (1979) Bell Journal of Economics, 74 at 77-9.

381 See Holmström at 77-9.

382 See Rees, 'The theory of principal and agent, Part 1', 37 (1985) Bulletin of Economic Research 3 at 6, 24.

shareholder.[383] Do we again have a fairness problem here? The answer is that there is no unfairness here. Dominant shareholders who concentrate their capital in one firm do not have the opportunity (like the average shareholder) to diversify away the firm-specific risk. Therefore, they have incentives to control the managers,[384] particularly because they will have great difficulties in selling their shares if the company performs poorly.[385] Their profits from insider trading are redistributed to the other shareholders in the form of the higher control effort undertaken by the dominant shareholder.[386] Again, here, interests equal out when the dominant shareholder makes some profits from insider trading.

d) The contract between company and manager

Such a contractual system has several advantages. The first is its flexibility. The 'democratic approach' takes into consideration that there are different character-types of managers; some are risk adverse, others like to take

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383 See Demsetz (Corporate Control) at 313 et seq.

384 If there is more risk one could be tempted to ask why people engage in such investments at all. It seems that dominant shareholders occur only in firms with high specific risks - where inside information is extremely valuable given the high volatility of the share price. More opportunity for profits, however, equal out the higher risk, see Demsetz, idem at 313 et seq.

385 Demsetz, idem at 314.

386 See Demsetz op cit at 313-315; for the opposite view see for instance Davidson/Solomon op cit (The agency origins of insider trading) at 88.
The present writer does on principle agree with Demsetz´s position. Yet two more arguments should be considered. Since substantial shareholders profit from their 'one-sided' investment insofar as they gain considerably more influence and control, they could also be asked to pay a little in return. Also, their decision was not forced - they could have diversified their portfolios like any other investor who accepts his position as minority shareholder. Thus it seems necessary to impose further duties on the substantial shareholder because he is in such a powerful position, see for this position Lutter op cit (Zur Treuepflicht des Großaktionärs). Yet in our capitalist societies it is good to have people who take up responsibilities in their companies; hey should be encouraged by the possibility of gaining as insiders rather than be deterred by prohibitions.

more risks. It is suggested that their salary consist of two components;[387] one should be a fixed income, and the other a flexible part based on the following factors: the risk-aversion of the manager; other available forms of payment (like bonus or options on stock); the risk aversion of the shareholders; the branch of industry; and the volatility of the shares in that particular branch (or company).

Some basic payment terms have already been discussed.[388] In addition, it is submitted that the cut in salary should be slightly lower than the expected gains from insider trades so that the insider can rely on a limited 'safety zone'. Thus he will not be pressured into exploiting each new piece of information fully. Such a safety zone would generate some transaction costs (residual costs), since the expected net gains destributed to insiders are perhaps not completely redistributed to the shareholders. However, it is more preferable (and less expensive) than relying on monitoring all the time: we must bear in mind that economic theory teaches us that some residual losses are inevitable, so that these residual costs seem acceptable

This solution would also create further incentives for the insider to raise his salary by the production of valuable information (one could call this a 'creativity bonus'), which will in turn increase the profits for the shareholder. Therefore, we can conclude that a balance will be reached between the interests. The conflict between shareholders and agents thus diminishes.

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387 See Laux, '(Pareto-) Optimale Anreizsysteme bei sicheren Erwartungen', 40 (1988) ZfbF 959 at 963-978.

388 See in the subsection on Manne's theory, above at p 67 et seq.

D. Summary of Part I

Part One of this thesis examined the economics of insider trading. By applying the main economic theories to the insider trading issue it became clear that there is no need for regulation prohibiting insider activity.

Insider trading was found to be neither immoral nor unfair. Therefore, regulation cannot be based on morality nor on fairness arguments. From an economic point of view it is uncertain whether or not insiders outperform the market - and if they do, whether that is to the detriment of the shareholders. The most important finding in this regard was that insiders do not necessarily cause harm to individual investors or groups of investors. We should abandon the linear idea that insider gains necessarily reflect harm caused to outsiders.

Even if the insider does outperform the average investors, the insider´s profits do not reflect losses incurred by outsiders. Due to the complicated system of pricing in stock markets, it is impossible to determine whether an outsider was harmed by an insider transaction. On the contrary, insider transactions are likely to enhance price accuracy, and thus the allocative efficiency of the market. It is more likely that insider trading and subsequent uninformed trading based on trade signals will protect market performance better than any type of prohibition. We have also seen that insider trading has no negative impact on disclosure: insiders will not postpone disclosure, because their gains depend on the announcement of new information.

As regulation and enforcement are costly, it was necessary to ask whether there are options other than prohibition to cope with the insider phenomenon. One economic approach was found to be particularly appealing: the agency relationship between manager and shareholders/firms. Based on the assumptions that the greatest amount of freedom should be granted to all market participants, and that managers (in their function as today´s entrepreneurs) should be rewarded properly for their work, it was suggested that they be permitted to trade freely on inside information as part of their compensation package. Objections to this approach such as the 'moral hazard' problem, 'adverse selection', and failure to protect markets were rejected.

The most important finding in that context was that at this stage of legal and economic research, it is impossible to determine whether or not insider trading is beneficial or detrimental. Interest analysis did prove, however, that the second-best informed persons, such as financial analysts, bankers, and brokers, have a specific interest in prohibition because their position enables them legally to exploit their informational advantage over the other market participants. Therefore, it is wise to be careful when such people propose regulation.

Given this uncertainty, it seems best to leave it to the parties involved to decide whether or not they feel that they need State protection. The 'democratic approach' combines both regulation and non-regulation, and achieves pareto improvements for the system as a whole. Firms are enabled to opt in or out of the statute system. If they opt in, they will have to pay the monitoring costs. If they opt out, they will enter into contracts with their managers specifying their compensation packages. This suits our pluralistic society, because there are different kinds of characters amongst managers and shareholders: risk-bearing or conservative, with high or low risk aversion. Some prefer risky projects which give opportunities for high returns on investment. The democratic approach is an answer to the plurality of characters, their various needs and aims in life. It is based on the ability of markets to find the best solution.

In the microcosm of the firm, as well as in the macrocosm of the markets, interests will equal out in a contractual system. As long as we do not know which solution is the best, we should grant opportunities. This will guarantee that people are satisfied with the market system and pursue their interests freely.

Part 2: Legal elements of insider dealing

Outline of Part Two of the study

Having examined the economics of insider trading, we shall now enter into the legal discussion of the topic. First we shall give a brief overview of the present legislation in South Africa, the European Union, England, and Germany. Then the study will elaborate on the problem of how to define 'inside information', because it is the main element of the insider trading definition. The comparison of the different legislative approaches makes it clear which legal and economic are currently favoured. It will be argued that some of these concepts are applied in an inconsistent way, mainly because they have been influenced by interest groups such as the financial services industry.

The European Directive on insider trading, for instance, chose the market-protection approach in terms of which insider trading is detrimental for the public trust in the market process. Yet, as we shall see later, this intention is not truly reflected by the Directive, because 'market protection' is still defined as 'investor confidence', which relates to the older concept of investor protection.

The overall purpose of the comparison is to determine the best legal options available. This is of importance for our suggetions in view of a Model Code in Part Three of this study. While examining the laws, we need to keep in mind that there is no economically reliable basis for insider trading prohibitions.

Chapter 1: The legislative situation in the three countries

In all legislation on insider trading we find certain elements that constitute the crime: the information; the definition of who is an insider; and the offences (including a list of securities in which insider trades can occur).[389] We shall examine the legislation of South Africa, England, and Germany in regard to these elements.

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389 See, however, Hopt, 'Europäisches und Deutsches Insiderrecht', ZGR 1991 at 17,

Before we go into detail, it is necessary to give an overview of the respective laws of these countries. The examination starts with South Africa, followed by the European law, European law being the source for both the English and the German insider trading prohibitions.

A. Insider trading prohibition in South Africa

As in many other countries, provisions aimed at regulating insider dealing have been extended in South Africa in 1990. Since the former provisions contained in ss 224 and 229-233 of the Companies Act 61 of 1973 were enacted, not a single person in South Africa was convicted[390] of contravening s 233,[391] which made insider dealing a criminal offence.[392]

The issue of insider trading was first seriously raised in 1970 when the 'Report of the Commission of Enquiry into the Companies Act' (the Van Wyk de Vries Report) was published.[393] Since Percival v Wright[394], it seems to have been generally assumed that directors have 'carte blanche' to utilise their inside knowledge in private speculation.[395] The South African company law at that time were therefore extremely outdated[396] in this regard.

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who subdivides insider dealing aspects into four parts: insider, inside information, securities and sanctions.

390 King Task Group, Draft Report on Insider Trading, 26 March 1997 at p 1. The same is true with regard to prosecution under the present law to the present date.

391 See, for instance, the excellent article by Jooste, 'Insider Dealing in South Africa', (107) 1990 SALJ 588 at fn 3.

392 Under the former provisions the penalty would have been a fine not exceeding R2.000 or imprisonment for a period not exceeding two years, or both the fine and imprisonment. See s 441(1)(b) of the Companies Act 61 of 1973.

393 RP 45/1979; Benade's brief summary in (1972) 16 Journ of Bus Law 167. The Commission also commented on other issues of company law and did by no means limit their enquiry to the issue of insider trading, cf Benade, 'A survey of the Main Report of the Commission of Enquiry into the Companies Act', (1970) CILSA 277.

394 [1902] 2 Ch 421. It was held that directors owe no fiduciary duties to the members.

395 Levin, 'Insider Trading in modern company law', (1967) 30 Tydskrif vir Hedendaagse Romeins-Hollandse Reg 137 (conclusion at 245) at 138.

396 Rider, 'The regulation of insider trading in the Republic of South Africa', (94) 1977 SALJ 437 at 437.

The earlier established Millin Commission[397] had merely proposed full and regular disclosure of all share dealings of directors or nominees in their company as the best remedy.[398] As a result, the companies were required to maintain a special register of shares and debentures held by the directors, whether personally or through nominees. This was meant to reveal what share dealings had taken place and when.[399] The information to be given by directors had to state, within 21 days of a securities transaction, the number, description and amount of shares and debentures held in the company, its holding company, and its subsidiaries or the subsidiaries of its holding company.[400] This proved to be both inappropriate and inefficient.

The Van Wyk de Vries Report recommended that insider trading in securities listed on a Stock Exchange should be made a criminal offence, carrying heavy penalties.[401] The anti-insider-trading provision introduced on the Committee recommendations provided that:

> 'every director, past director, officer or person[402] who has knowledge of any information concerning a transaction ... of a company ... which if it becomes publicly known, may be expected materially to affect the price of the shares ..., and who deals in any way to his advantage ..., shall be guilty of an offence.[403]

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397 Final Report of the Company Law Amendment Inquiry Commission (1947-48) (UG 69/1948).

398 Just like the Cohen Committee at that time in England, cf para 87, which led to s195 of their Companies Act corresponding closely to s70nov of the South African Companies Act 46 of 1926; see Levin op cit at 138.

399 Levin op cit at 138; cf sections 70nov et seq of the Companies Act 46 of 1926 and Companies Amendment Act 46 of 1952.

400 Sec. 70nov (11), (12) of the old Act as amended by Act No. 46 of 1952, see Emmett/Barlow, 'Principles of South African Company Law', Cape Town, Wynberg, Johannesburg, 6th edition 1969 at p 149; cf also Palmer/Light, 'Company Secretarial Practice in South Africa', 3rd edition 1958 at 247 et seq.; cf also Leveson 'Company Directors', Durban 1970 at 21 et seq.

401 § 44.57 and Recommendation 106.

402 For the scope of insiders see the comments in Joubert, 'The Law of South Africa', Vol 4 paras 249, 251 at fn 2-5.

403 Former s 233 of the Companies Act 61 of 1973.

This form of insider regulation had serious shortcomings,[404] in particular concerning take-over situations[405] where it seemed that officers and directors of the target company were not within the ambit of the insider-definition when buying shares of their own company[406], because the take-over would not have been a transaction of their company.

It was therefore obvious that the provision needed to be reviewed - and moulded in a more appropriate way. In the 1989 Companies Amendment Act[407] and the 1990 Companies Second Amendment Act[408] the legislator enacted provisions that were designed to cope more efficiently with the misuse of 'inside information'.

The 1989 Companies Amendment Act[409], which was repealed by the 1990 Companies Second Amendment Act, never came into force. The old s 440F of the 1989 Act had contained provisions which reflected[410] a very generous borrowing[411], and in places verbatim copying, from rule 10b-5,[412] adopted by the Stock Exchange Commission (SEC) in the USA under s 10(b) of their Securities Exchange Act of 1934.[413]

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404 Rider op cit at 448.

405 Du Plessis, 'Binnekennistransaksies by oornames en samesmeltings', (1989) 1 SA Merc LJ 46 at 47.

406 Du Plessis, 'Enkele probleme met betrekking tot binnekennistransaksies by oornames en samesmeltings van maatskappye in die Suid-Afrikaanse maatskappyereg', Master Thesis at the Universiteit van Suid-Afrika, 1988 at 50 et seq.; with regard to the aforementioned shortcoming and others see Van Zyl, 'Die bekamping van binnekennistransaksies in Suid-Afrika', (1989) 77 TSAR 77 at 79.

407 Act 78 of 1989.

408 Act 69 of 1990.

409 Act 78 of 1989.

410 Luiz, 'Prohibition against trading on inside information - the saga continues', (1990) 2 SA Merc LJ 328 at 328 says that it was a mirror image of rule 10b–5; the present author does indeed agree with this contention.

411 In particular s 440F(1): 'Any person who, ... in connection with the purchase or sale of any security (a) employs any device, scheme or artifice to defraud any person; (b) makes any untrue statement of a material fact ... . For an anylysis of the provisions of the 1989 Act see Luiz, 'Insider trading: A transplant to cure a chronic illness?', (1990) 2 SA Merc LJ 59 at 61; see (also for the 1989 Act), analysing the difficult issue of what sanctions should be imposed, Jooste, 'Insider dealing in South

The new s 440F which has been in effect since 1 February 1991[414] contains no such 'plagiarism'. The reason given by the Memorandum on the Objects of the 1990 Companies Second Amendment Bill[415] for the substitution of the new s 440F was 'the perception, and indeed the fear, of some South African financial institutions that the net has been cast too widely and that important, innocent investment activities are included in the programm.'[416]

The present legislation is to be found largely in the new chapter XVA of the Companies Act 1973, containing the new sections 440A to 440N. These have come into force at various dates between 1 October 1989 and 1 February 1991.[417] The following statutory framework is provided:[418]

-The establishment[419] of the Securities Regulation Panel[420] with, inter alia, the function of supervising dealings in securities. The Panel is granted powers of subpoena and interrogation for the purposes of performing its functions.[421] It has the power to impose an obligation on certain persons to disclose information to the Panel relating to their beneficial holdings of

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Africa - the civil aspects', (Winter 1990) 4 De Ratione 29-33 and Jooste, 'Insider dealing in South Africa - the criminal aspects', (Winter 1990) 4 De Ratione 21-28.

412 Issued in 1942, making it unlawful '(1) to employ any device, scheme or artifice to defraud'; '(2) to make any untrue statement of a material fact ...'; cf, for instance, Levin op cit at 251.

413 Jooste op cit note 142 at 591.

414 Government Notice R10 of 1991; see Schoeman, 'Guide to the companies act and regulations', Revising editor Walter D Geach, Cape Town, Wetton, Johannesburg, 1992, service No 21, 1994, at 10-204F.

415 B 119B-90 (GA) at 17.

416 Ibid.; for a comment on the second fear, which is that South African common law concepts on fraud differ from those in the USA, see Jooste op cit at 591 fn 17.

417 Jooste, 'Insider trading, A new clamp-down', (1991) 20 Businessman's Law 248 at 248 fn 3; see J T Pretorius (ed) Companies Act 61 of 1973 and Close Corporations Act 69 of 1984, 1991 at 340.

418 See Jooste op cit at 588 et seq.

419 Sec. 440B of the Companies Act 61 of 1973. The sections referred to hereinafter are those of the aforementioned Act as long as further specification is not given.

420 Hereinafter referred to as 'the Panel'.

421 Sec. 440D.

securities.[422]

-Insider dealing is still a criminal offence;[423] now, however, in terms of a wider definition, and subject to stiffer penalties.[424] Moreover, a statutory civil remedy for the benefit of a victim of insider dealing was created.[425]

The role of the Panel is undoubtedly viewed as crucial to curtailing insider dealing. It is hoped that the Panel will have at its disposal the type of professionalism, independence and experience which is required to assist the commercial branch of the police force and the Attorney-General's office in giving effect to the substantive statutory provisions aimed at preventing insider dealing.[426] In the absence of the Panel, Jooste[427] believes that it is unlikely that the new provisions on insider trading would be more effective than the old ones.

The economic literature in South Africa has not contributed any important insights to the worldwide debate. With the exception of Botha[428], Kantor[429] and Swersky[430], the dominant opinion in the literature is, surprisingly, but almost unanimously, in favour of provisions banning insider trading.[431] The

422 Sec. 440C(1)(b).

423 Sec. 440 F.

424 Sec. 441(1)(a).

425 Sec. 440F(4).

426 Jooste op cit at 589.

427 Idem, at 589.

428 'Aspects of capital market efficiency and statutory regulation of insider trading in South Africa', Journ Stud Econometrics 1991, 15(2), 57 at 67.

429 'In support of insider trading - More than a zero-sum game', (1991) 20 Businessman's Law 167.

430 'Should the net be extended? A contrary view', unpublished LL.M-dissertation, UCT 1987.

431 See for instance Davidson, 'Insider trading - a reply to Brian Kantor', (1991) 21 Businessman's Law at 94 who is of the opinion that allowing insider trading on the JSE would result in a loss of credibility on the part of the stock market as an institution, idem at 96. This approach is, however, intuitive or even emotional rather than based on empirical findings.

first issue to be considered was, of course, the capital market efficiency.[432] Botha[433] quoting Manne[434] and Wu[435], who both stated that insider dealing strongly relates to informational efficiency[436], raises this point in the South African economic literature.

Some empirical studies have been carried out by Bhana[437] (disputed and criticised[438] though) indicating abnormal returns on the Johannesburg Stock Exchange (JSE). Bhana argues that the semi-strong form of the 'efficient capital market hypothesis' (EMCH), ie that all publicly available information is reflected by the share price, cannot be applied to the JSE.[439] If this thesis were supported by more empirical research[440], it would be a setback for any attempt to regulate insider dealing, because all insider trading prohibition relies on the applicability of the EMCH.

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432 Botha op cit at 57.

433 Op cit at 60.

434 Op cit.

435 Wu, 'An economist looks at section 16 of the SEA of 1934', (1968) 29 Columbia Law Review 260 at 266-269.

436 Botha op cit at 57 fn 1.

437 Bhana, 'Take-over announcements and insider trading activity on the Johannesburg Stock Exchange', (1987) SA Journal Bus Mgmt 198; for further empirical research see the references in Botha op cit at 59 indicating indeed that the informational efficiency on the JSE is rather weak.

438 R.C. van den Honert & G.D.I. Barr, 'A comment on take-over announcements and insider trading activity on the Johannesburg Stock Exchange', SA Journal of Bus Mgmt 1989 at 93; indirectly critisised also by Botha op cit note 19 at 67 who thinks that the informational efficiency would seem to have been better under the old s 233.

439 Bhana op cit at 207.

440 See, however, Bhana, 'Significant changes in dividend policy and insider trading activity on the JSE', (1991) 22(4) SA Journal Bus Mgmt 75 at 81, who ascertains that - concerning insider trading prior to dividend announcements - the existence of large insider profits is inconsistent with the strong form of the EMCH; see also Davidson and Solomon, 'The agency origins of insider trading', (1991) 22(4) Journ Bus Mgmt 87, who analyse insider trading as an agency problem.

B. European Law

Since the European Communities[441] adopted the 'Council Directive coordinating regulations on insider dealing (89/592/EEC)'[442] on the 18th November 1989, insider trading provisions became part of the European capital market law. In order to effectively counter insider trading at an international level, the Member States of the Council of Europe have agreed on a 'convention on insider trading'[443], the main goals of which are to enhance the exchange of information between Member States (in terms of the convention the 'Parties'),[444] and mutual assistance in criminal matters[445]. This, rightly, takes into account that ' given the ease of present-day communications, securities operations are carried out by persons not resident in that State' (ie the State on whose market the insider transactions are carried out).[446]

For a better understanding of both the English[447] and the German[448] laws

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441 According to the Treaty of Maastricht we will further talk of the European Union (EU), but at the time of the approval of the insider dealing Directive by the European Council, there were still the European Communities.

442 OJ No L 334/30.

443 Opened for signature on 20 Apr 1989; (Parliamentary Assembly 27 Jan 1989, Doc 5993 addendum; reprinted for instance in: Hopt/Wymeersch (eds) op cit note 36 at 388 et seq.; for an overview of the convention and the goals persued by it see Lowry, 'The international approach to insider trading: The Council of Europe´s convention', (1990) Journal of Bus Law 460; for a wider context, eg the Community´s attempt to create a single regulatory framework for a European securities market see the excellent overview provided by Garzaniti/Pope, 'Single market-making: EC regulation of securities markets', 14 Comp Law 1993 at 43.

444 Chapter II of the convention, Artt 2-11.

445 Chapter III of the convention.

446 Cf para 4 of the preamble to the aforementioned convention.

447 See, therefore, English comments on the Directive and its implementation in English domestic law: Davies, 'The European Community´s Directive on insider dealing: From company law to securities markets regulation?', (1991) 11 Oxf Journ of Legal Studies 92; Tridimas, 'Insider trading: European harmonisation and national law reform', (1991) 40 Intern and Compar Law Quarterly 919; Ashe, 'The Directive on insider dealing', 13 Comp Lawy 1992 at 15; Dine, 'Implementation of the EC insider trading Directive in the UK', 14 Comp Lawy 1993 at 61; Rider and Ashe,

on insider dealing, a closer look at the European Directive is needed, because the Directive finally resulted in a new domestic legislation in these Member States. The Directive has raised considerable interest in the literature.[449] What will be said in this subsection is equally true for both England and Germany.

I. How European law works - some general remarks

Some preliminary remarks on European law are essential for the understanding of the English and the German insider trading provisions.

'The insider dealing diective', in: Andenas/Kenyon-Slade, 'EC financial market regulation and company law', London, 1993, chapter 12.

448 For the German interpretation of the Directive see Hopt op cit (ZGR 1991); also Hopt, 'The European insider dealing Directive', (1991) 27 CMLR 51; Grunewald, 'Neue Regeln zum Insiderhandel', ZBB 1990 at 128; Schödermaier/Wallach, 'Die Insider-Richtlinie der Europäischen Gemeinschaft,' EuZW 1990 at 122; Claussen, 'Neues zur kommenden Insidergesetzgebung (II)', ZBB 1992 at 73; Tippach, 'Marktdaten im künftigen Insiderrecht?', WM 1993 at 1269; the possible economic impact of the Directive is discussed by Ott/Schäfer, 'Ökonomische Auswirkungen der EG-Insider-Regulierung in Deutschland', ZBB 1991 at 226; see further Hübscher, 'Die Umsetzung der Regelung der Insider-Geschäfte in Deutschland' in: Büschgen/Schneider, 'Der europäische Binnenmarkt 1992' at 315; Stumpf, 'EG-Insiderrecht: Die Insider-Richtlinie als Bestandteil eines europäischen Kapitalmarktrechts', 1990 Jahrbuch Junger Zivilrechtswissenschaftler 31, who places the Directive in the context of the European capital market law.

449 See the bibliographical references given above; a detailed comparative analysis is provided by Wymeersch, 'The Insider Trading Prohibition in the EC Member States', in: Hopt/Wymeersch op cit at 65; Pingel, 'The EC Directive of 1989', in: Emmanuel Gaillard (ed), 'Insider trading - the laws of Europe, the United States and Japan', Boston, 1991, 5; Schödermeier/Wallach, 'The EEC insider Directive approaching final adoption', 5 Journal of Intern Banking Law 1989 at 234; for a South African standpoint see Van Zyl/Joubert, 'The European Union Directive on insider trading: A model for South Africa?', (1994) 6 SA Merc LJ 291, these authors state that the Directive fails to determine effective (criminal) sanctions, idem at 301. It should be clarified that the EU is not competent to impose sanctions on individuals and therefore correctly refrained from such provision; for an analysis of the European Directives (including the insider Directive) on the harmonization of company law see Delport (1992) 4 SA Merc LJ 198.

Though the main decision-making body in this process is still the European Council, which consists of representatives of the governments of the Member States, in recent years there has been an increase in legislative power in favour of the European Parliament.[450]

European law consists of several categories of statutes and rules which differ to a large extent in application and impact. The first very important source of law is the 'regulation' (dt.: Verordnung) as a form through which the EEC and further the EU can make legal rules for the Member States. The 'regulation' is a very strong legal measure because it is directly binding and applicable in all the European countries. It is self-executory and directly applicable, so that no further act by the Member States is necessary. There is, for instance, no need to transform such 'regulations' in national law. It is, however, not possible to use the 'regulation' for legal issues with regard to citizens, especially not where criminal law is involved,[451] as is the case with the Insider Dealing Directive. These matters still fall within the competence of the Member States. For this reason the insider problem could not be dealt with through a regulation.

The other way of making European law is the 'recommendation' (dt.: Empfehlung). The Commission makes use of this form when it wants to express an opinion on a specific and relevant matter. Its advantage is that there is no need to justify it or even pass it in the European Parliament. Because many of these recommendations have subsequently resulted in a Directive or a regulation[452], Member States are given the opportunity to

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450 Marking Hall was the single European Act in 1986 which considerably widened the powers conferred on the European Parliament, namely that no legally binding rule can be made against the express will of the majority of the members of Parliament.

451 To my knowledge there is not a single writer who expressed the view that criminal law would fall within the competence of the European Union. For the dominant opinion, within the EU, see OJ EEC No C 35, 8 Feb 1988 at 23 sub No 1.7; Lord Cockfield, in sessions of the European Parliament, 15 Jun 1988, No 2-366/150; for the German view see Tiedemann, 'Europäisches Gemeinschaftsrecht und Strafrecht', NJW 1993 at 23. The same view is taken by the English literature, see for instance Hannigan, 'Regulating insider dealing', JIBL 1989, 11 at 14.

452 Especially in capital market matters see EEC recommendation OJ EEC No L 212, 20 Aug 1977 at 37 et seq. which has had considerable impact on the present legal system with regard to securities markets, see Welter, 'Die Maßnahmen der

think about the contents and are invited to state their opinion.

The disadvantage of a recommendation is that it is not binding at all. Therefore, it does not bring about any formal change in the law of the Member States. Because insider trading was regarded by the governing bodies of the EC as an important matter comparable to money laundering[453], there was no doubt that a recommendation was not an appropriate means of harmonizing the laws on insider dealing in the Member States.

II. European decision with regard to the legal means by which insider trading was finally addressed

For the above reasons the European legislator considered a Directive to be the most appropriate way of ensuring conformity among insider trading laws in Europe, thus creating equal market and investor protection on the competing capital markets of all Member States´. The insider dealing Directive was received without dissenting vote in the Council, indicating that none of the Member States governments were opposed to it, and it was also passed by a vast majority in the European Parliament.

III. Functioning and interpretation of a Directive

After the final text of a Directive has been passed by the European Parliament, it has to be transformed by the Member States into their respective national laws. To achieve this, a special (national) act is required. For this purpose it would, for example, not suffice that the pre-existing law in accordance with the Directive, or that it has been the prevailing opinion of the courts (eg in Germany), or that it reflects the position at common law (eg in England).[454] New national legislation becomes necessary when a Directive is adopted.

It is important to note that any national Court whose members are uncertain

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Europäischen Gemeinschaften im Bereich der Insidergeschäfte', in: Büschgen/ Schneider op cit 315 at 318.

453 Sir Leon Brittain, 'Money laundering', in: L´ Ethique des Marchés Financiers, Publié sous la direction de Jean-Victor Louis et Diego Devos, Brüssel, 1991 at 15.

454 Hilf, 'Die Richtlinie der EG - ohne Richtung, ohne Linie?', EuR 1993, 1 (14); Wägenbaur, 'Umsetzung von EG-Recht in deutsches Recht und ihre

about the meaning of a section in the national law, which is based on European law (regardless of whether it stems from a regulation or from a Directive), is obliged to ask for clarification by the European Court of Jusitce[455], cf Art 177 EUT.

In general, different methods of interpretation are applied by the European Court. First, the Court considers the wording and thus attempts to reach an objective interpretation.[456] This is not an easy task, because the text is authentic in all languages of the Member States.[457] Secondly (and most importantly), the Court uses teleological interpretation, ie takes into consideration the intentions of a Directive.[458] Most often reference is made to such intentions in view of harmonising national laws in the common market. It is of particular importance that the intentions of the European legislation will bind the national courts when they need to interpret the national law which is based on a Directive.[459]. Therefore, it is most important to analyse what precisely these intentions (the 'telos') are.

Usually, those intentions are outlined in the preamble of a 'Directive'. The Directive and the national law based on it need to be interpreted in the light of the 'telos' which is explained in a preamble.[460] Thus a Directive does not lose its importance once it has been transposed into the domestic laws.

Thirdly, and only where the above principles provide no ansewer, the European Court refers to 'historical' interpretation (ie subjective methods

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gesetzgeberische Problematik', ZG 1988, 303 at 305.

455 Everling, 'Vorabentscheidungsverfahren vor dem Gerichtshof der Europäischen Gemeinschaften', Baden-Baden, 1986 at 27 et seq.

456 ECtJ ECR 1976, 455 (472 f., 479) - Gabrielle Defrenne; see Bredimares, 'Methods of Interpretation and Comunity Law', Amsterdam, Oxford, New York, 1978, for an early, but still comprehensive overview of the interpretational approaches of the European Court of Justice.

457 See the excellent article written by my academic teacher, Prof. Dr. Dr. hc Lutter, 'Zur Auslegung angeglichenen Rechts', JZ 1992, 593 at 599.

458 ECtJ ECR 1985, 2655 (2668) - Kommission ./. Deutschland; in the literature see Bleckmann, 'Probleme der Auslegung von EWG-Richtlinien', RIW 1987, 929 at 933; Lutter op cit at 602 et seq.; see also the former judge at the European Court of Justice, Prof. Dr. Everling, 'Zur Auslegung des durch EG-Richtlinien angeglichenen nationalen Rechts', ZGR 1992, 376 at 386.

459 ECtJ ECR 1989, 3533 (3546) - Nijman; Lutter op cit at 604 et seq.

460 Lutter op cit at 600; Bleckmann op cit at 930.

of interpretation). And this only when so-called secondary[461] European Law (eg 'Directive' or 'Regulation') has to be interpreted.[462] This has occured very rarely. Practically no importance has therefore been attached to subjective interpretational methods. And because national legislators are bound by a 'Directive', it is indeed pointless to turn to *national* debates about the final text of the law in national Parliaments. Whatever their national intentions might be when they made the law, these would be ignored by the European Court of Justice if the *European* intention was different.

In England, the recent House of Lords decision in *Pepper (Inspector of Taxes) v Hart* [463] reversed a longstanding rule that debates in Parliament on legislation could not be used to establish the meaning of the legislation. Thus, the historical-subjective dimension of interpretation is now permissible in the English Courts. But for the afore-mentioned reasons, if European law is at issue, this approach is permissible.[464] The European Court has the power to reject any interpretation submitted by national Parliaments.

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461 The term 'primary European law' includes only the Treaties of Rome and modifications apported to them such as the Single European Act 1986. All other legislative actions, in particular Directives and Regulations, are subsumable under the term Secondary Law, see Ipsen, 'Europäisches Gemeinschaftsrecht', 1972 at 111. With regard to Directives, the European Court of Justice takes into consideration the drafts which preceded the text of a Directive that was finally adopted, cf, for instance, ECtJ ECR 1985, 3909 at 3930 - Mainfrucht Obstverwertung; see Lutter op at 599 et seq.

462 See ECtJ ECR 1976, 153 (160) - Süddeutsche Zucker -.

463 [1993] 1 All ER 42.

464 Therefore, it is respectfully submitted that the view expressed by Alcock op cit at 67, is far too optimistic with regard to the guidance in interpretation given by Minister Nelson´s interesting 'explanations' on the new provisions on insider trading in the CJA 1993 Part V. Whenever an interpretational problem is at issue, the European Court will certainly not consider a national legislator´s reasoning as a guideline.

C. England: From the Companies Securities Act 1985 to the Criminal Justice Act 1993 (Part V)

Until 1980, the restrictions on insider trading in the United Kingdom were extremely limited. There was no statutory prohibition of insider practices, nor did the common law make insider trading actionable.[465]

In the leading case of Percival v Wright,[466] the Chancery Devision of the High Court held that a corporate director owed a fiduciary duty only to the company - not to its members - thus he was not obliged to disclose information about the company to the shareholders before trading with them.

Although the City Panel on Takeovers and Mergers and the London Stock Exchange (LSE) disapproved[467] of the practices of insider trading and 'tipping', their rules and guidelines were not strictly enforced.[468] Insider dealing was first made a criminal offence by the Companies Act 1980. Since 1985 insider dealing regulations were contained in the Company Securities Act (CSA), also named Insider Dealing Act (IDA).[469]

Many provisions of the CSA originate with the 1980 Companies Act.[470] Through the Financial Services Act 1986 certain enforcement provisions were implemented.[471]

Part V of the 1993 Criminal Justice Act (CJA), which received Royal Assent in July 1993, seeks to implement the European Community Council Directive co-ordinating regulations on insider dealing.[472] The provisions of the CJA 1993 are to be applied in relation to offences allegedly committed

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465 Poser, 'International Securities Regulation', Boston, London, 1991 at 159.

466 [1902] 2 Ch 421.

467 City Code on Takeovers and Mergers, Rule 4.1.

468 Poser op cit at 160.

469 Hannigan,' Insider Dealing', 2nd edition, London, 1994, at 14 et seq.; Both abbreviations (CSA and IDA) will be used hereinafter when reference is made to the former English law on insider trading.

470 Davies op cit at 98; Hannigan at 14; Gore-Browne on Companies, 44th Edition, Supplement 17, Bristol, 1994, §12.18 at 12.024.

471 See Rider/Abrams/Ferran 'Guide to the Financial Services Act 1986', 2nd edition, Bicester, Oxfordshire, 1989 at 130 et seq.

472 For an overview of the present legislation see Lomnicka, 'The new Insider dealing provisions: Criminal Justice Act 1993, Part V', Journ of Business Law 1994 at 173.

on or after 1 March 1994, wholly superseding the Company Securities Act 1985. The provisions contained in Part V of the CJA 1993 also reflect how Parliament and City have reacted to the European Directive.[473]

Even though Part V of the CJA 1993 completely replaces the 1985 Act, it does not seek to consolidate all provisions which are relevant to insider dealing. For example, the provisions relating to investigation remain part of the Financial Services Act 1986.[474] The Criminal Justice Bill, which introduced the Government's views on those aspects of the law which required modification, met a barrage of criticism from the professions and the City. The criticism focused on the broadening of the offences to catch conduct, which was thought to be unobjectionable and even beneficial for the market. The Government was forced to introduce completely redrafted sections in the committee stage in the House of Commons.[475]

Whilst many of the constituent elements of the three main insider trading offences remain similar to those in the 1985 Companies Securities Act, they have been refashioned and modified in certain important respects. Therefore, both jurisprudence and experience of the earlier legislation must be regarded with suspicion as far as its applicability to the new law is concerned.[476] This is all the more true because the interpretation will from now on depend largely on the conception and definitions provided by the European Directive. It is conceivable that, should a divergence between the Directive and the 1993 Act become apparent, litigants, assuming that they have a viable cause of action, might seek to utilise the provisions of the Directive in a suit against an insider.[477]

Consequently, not a single item of really relevant insider dealing case-law is available at present. The recently reported decision of the Court of Appeal in R v Goodman[478], was still based on the 1985 (Insider Dealing) Act, because the alleged contraventions had taken place before 1 March 1994.

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473 Wotherspoon, 'Insider Dealing - The New Law: Part V of the Criminal Justice Act 1993', (1994) 57 Modern Law Review 419 at 420.

474 Gore-Brown, at 12.024.

475 Gore-Brown, idem at 12.025.

476 Gore-Brown op cit at 12.024.

477 Gore-Brown, idem §12.22 at 12.031.

478 [1994] 1 BCLC 352.

D. Germany

Until July 1994 one could say without hesitation that Germany had very few laws on securities.[479] The capital market, especially in regard to the Stock Exchange, was relatively undeveloped. However, since 1993, the Stock Exchange in Frankfurt (which is the most important one in Germany)[480] has undergone extensive development both legally and economically. The former predominance of smaller companies (Gesellschaft mit beschränkter Haftung, GmbH; engl.: limited liability) was due to family ownership and the reluctance to comply with more burdensome disclosure requirements and increased rights of workers to participate in management (so-called 'Mitbestimmung') which accompany a conversion into stock corporations.

Now that the need for international co-operation is felt by all, Frankfurt and the German legislature have become concerned about capital market structures. The implementation of the European Directive was incorporated in a new Act on securites trading ('Wertpapierhandelsgesetz')[481]. This new Securities Trading Act and extensive amendments[482] of the Stock Exchange Act ('Börsengesetz') form part of the most important legal project on economic law in recent years: the 'Zweites Finanzmarktförderungs-Gesetz'[483].[484]

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479 Poser op cit at 394 et seq.; see also Mennicke, 'Insider regulation in Germany: the change from self-regulation to criminal law', 15 Comp Lawy 1994, 155 at 155.

480 Altogether there are eight German stock exchanges: Frankfurt, Düsseldorf, Berlin, Hamburg, Munich, Hannover, Stuttgart and Bremen. Of these, Frankfurt is by far the largest and most significant. It is appropriate to refer to 'Frankfurt' when talking about the German capital markets.

481 Abbreviated hereinafter as 'WpHG'.

482 Among the most important are: the creation of a new enforcement agency, the Federal Authority for the Supervision of Trading in Securities (Bundesaufsichtsamt für den Wertpapierhandel), the legal acceptance of the installation of IBIS (the new electronic trading system) and new rules for funds-management - cf the introductory remarks in Schwark, Kommentar zum Börsengesetz, 2. Aufl., 1994, Einleitung.

483 BR-Drucks. 585/94, 17 Jun 94.

484 For an overview of the provisions contained in the legislation, in particular the European perspective of the recent development see Krimphove, 'Das zweite Finanzmarktförderungsgesetz', JZ 1994 at 23; see also Weber, 'Deutsches

Formerly, the German law did not provide any particular provisions on insider trading. Neither provisions related to the misuse of information (in the Stock Corporations Act, dt.: Aktiengesetz), nor provisions on securities fraud (in the Stock Exchange Act, dt.: Börsengesetz), provided adequate tools for combatting insider trading.[485] There was only a Code of Voluntary Insider Trading Guidelines, a system which combined both inefficiently and deficiently[486] compliance rules with self-regulation. The Guidelines did not have the force of law, because adherence was based upon a dual system of contract.

The system was established to function as follows.[487] First, there was a contract between an umbrella body and its corporate members. Secondly, the corporations were then held to require their senior management, supervisory board and other potential insiders to abstain from insider trading. This was to be enforced by contract between the corporation and the potential insider. In most cases such agreements were embodied in the contract of employment.

One of the major deficiencies was perfectly illustrated by the recent Steinkühler case[488]. Steinkühler, former chairman of the Metal Workers' Union and member of the supervisory board of Daimler Benz, had not - previous to his alleged insider dealing - entered into a contract and was therefore not bound by the Guidelines. Consequently, the Board of Inquiry[489] of the Frankfurt Stock Exchange was unable to investigate the

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Kapitalmarktrecht im Umbruch', NJW 1994 at 2849.

485 Cf Mennicke op cit at 155.

486 Hauschka/Harm, 'Zur Reformbedürftigkeit des deutschen Insiderrechts', BB 1988 at 1189; see also Mennicke, op cit at 156 et seq.

487 Cf Baumbach/Duden/Hopt, Handelsgesetzbuch, 28ed, München 1989 at 1470 et seq.

488 Referred to in Mennicke op cit at 155; this case has also incited - for the first time in Germany - the interest of the public, see reports in newspapers, for instance, FAZ No 114, 18 May 1993 at 13 et seq.; Der Spiegel 21/1993 at 32; Stern, 27 May 1993, 32 at 36; Die Zeit, 28 May 1993 at 25.

489 Established at each of the German stock exchanges already in 1971 according to the Rules of Procedure (Verfahrensordnung) in order to investigate insider dealings which were within the scope of the Guidelines (as revised in 1988) and the Broker and Investment Adviser Rules (Händler- und Beraterregeln).

case.[490] The humorous aspect of the Steinkühler case was that, according to the philosophy of the Confederation of German Trade Unions, the self-regulatory system was not sufficient. They opposed it on principle; and the Confederation's members would generally not enter into the aforementioned contracts, and thus not adhere to the voluntary regulation.[491] As a result of this Mr Steinkühler was not even bound contractually, although the Trade Unions always wanted stricter legal and statutory rules on insider trading to be promulgated.

The old system is now completely superaded by the regulations of the 2nd Finanzmarktförderungs-Gesetz. The 'new' (ie the first) German insider trading provisions have been influenced in their terminology by Anglo-American examples. English expressions such as 'insider' are used in the official German texts.[492] The long tradition of English insider trading provisions in general, and the lively English debate, influenced to a large extent the final wording of the European Directive, which finally became the source of the 'German' (it is regarded above of all as 'Community Law') law on insider trading. Therefore, the English legal development deserved far more consideration by the German legislator than it was actually given.

It is interesting to note that most German economists who expressed their views on the new insider dealing prohibitions stated that, economically, it would not make much sense to regulate the phenomenon of insider trading at all.[493] They refer mainly to capital market theory, market processes theories, and to agency relationship theory, which have been dealt with in Part I of this study. The debate on this issue is still going on, even though the new law came into force on the 1st of January 1995.

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490 Mennicke, op cit at 156.

491 Dingeldey, 'Insiderhandel und Strafrecht' at 37.

492 The term 'insider' is used in official German language and also in the legal provisions, whereas the adequate transformation 'Innenseiter', suggested in the 70ties by Horn, 'Wertpapiergeschäfte von Innenseitern als Regelungsproblem', (1972) ZHR 136 at 369, was never received with approval.

493 Schörner op cit at 247 et seq.; Schneider op cit at 1429 et seq.; for the view that only some aspects of insider trading should be regulated see Lahmann, 'Verbot des Insiderhandels, Ökonomische Analyse', München, Berlin, 1994; in favour of a regulation on a voluntary basis Schmidt op cit at 38.

Chapter 2: The definition of 'inside information

The starting point for any legal discussion of insider trading must be a consideration of what is 'inside information', the possession of which is the key element to fall within the statutory provisions. We can debate and argue at length whether or not non-corporate people such as market-insiders (eg: brokers, analysts, or market makers) should fall within the scope of the dealing prohibition; but without a definition of the information on which the insider may not trade the prohibiton would not be clear. 'Inside' information will also to a certain extent define the 'insider': if, for instance, market information is not caught within the ambit of this definition, a broker is not an insider, because he has access only to market information (unless he receives information from a company insider, of course).

A. Basic criteria for 'inside information'

In all legislation there are three important parts of the information-definition: non-public, price-sensitivity, and scope. All insider legislation contain variations on these main themes. At this stage we shall not explain in detail the possibilities of these variations, because this will be part of the comparative analysis. Here we shall only consider the basic concepts. Questions such as whether or not the information must result in a 5% price change on announcement, or whether it must be generally available before it can be regarded as public, will be dealt with further on in the analysis of the different laws.

'Non-public' can be interpreted as not yet published, or as not yet digested by market participants. Where one chooses 'not published', it becomes necessary to define the media through which the information is usually published. For instance, is publication in a newspaper necessary, or is the ticker-tape on the Stock Exchange sufficient? If time for proper consideration of the information is required, is one day sufficient? It is obvious that dealings are facilitated, if the information is 'public' at the very moment it comes through on the ticker-tape. Where that is the case, *early* trading after announcement would not be insider trading. If, however, new data need to be digested, much more trading will be regarded as 'insider' trading. Hence the trading volume will decrease which may have negative effects on the liquidity of the market.

The second key problem is the 'price-sensitivity' of information. Price-sensitivity can be interpreted in an objective or in a subjective way. Information is objectively price-sensitive, for instance, where the legislation provides for a price change of more than 3% after release. The debate under such a system would be whether or not 3% is enough.

A subjective interpretation is applied where it is required that (groups of) traders need to assume that the information is price-sensitive. Such an approach is, for instance, when one asks whether 'the reasonable investor'[494] would have regarded the respective information as important for his trading decision. Whether an ex-ante view needs to be applied or whether it is perhaps better to define price-sensitivity ex post (ie after the price reaction has taken place), this needs to be discussed later. A subjective approach normally results in a more vague interpretation, and the insider sometimes does not know whether or not his transactions are prohibited.

Thirdly, it is important to understand that the scope of information can vary. If market information such as trading volumes is encompassed, the number of insider transactions prohibited will drastically increase. Then, of course, the term 'market information' needs further clarification. For instance, is political information to be included, or changing of interest rates (central bank policy), or recommendations of brokers to their customers? If the legislator decides that only company information is potential insider knowledge, one will have to examine whether or not take-overs and bids are company information. One could argue that these are market transactions as opposed to, for instance, new product development within a company (ie clearly endogenous information).

At this stage it suffices to observe that these three criteria can be used as variables to extend or narrow the scope of stock transactions which fall within the ambit of insider dealing prohibitions.

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494 The 'reasonable investor'-approach is highly debated, see, for instance, Newmann, Jr./Herrmann/Ritis, 'Basic truths: the implications of the fraud-on-the-market theory', (20) Journ of Corporation Summer 95, 571 at 583 et seq, who say that 'materiality should be viewed from a standoint of a professional investor, because they play the key role in setting the market price'.

B. Inside information in South African law

I. Overview: the elements of 'inside information'

The definition of 'inside information' is now contained in s 440F of the Companies Act 61 of 1973. According to s 440F(1) the insider must 'knowingly deal in a security on the basis of unpublished price-sensitive information in respect of that security.'

For the information to fall within this definition it has to relate 'to matters in respect of the internal affairs of a company or its operations, assets, earning power or involvement as offeror or offeree company in an affected transaction or proposed affected transaction;'[495]. An 'affected transaction' means any transaction (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which -

> (a) taking into account any securities held before such transaction or scheme has or will have the effect of -
>
> > (i) vesting control of any company ... in any person ... in whom control did not vest prior to such transaction or scheme or
> >
> > (ii) any person ... acquiring or becoming the sole holder of all the securities ... .[496]

Information falls within this definition only if it is 'not generally available to the reasonable investor in the relevant markets for that security'.[497] The test to be applied is whether a reasonable investor would have been aware of the information.[498] 'Generally available' in terms of the legislation means 'available in the sense that such steps have been taken, and such time has elapsed that it can reasonably be expected that such information as referred to in paragraph (a) (ie unpublished price-sensitive information in respect of a security) is or should be known to such investor as referred to in subparagraph (ii) of paragraph (a) (ie the reasonable investor in the

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495 Sec. 440F(2)(a)(i).

496 Sec. 440A, definition of 'affected transaction' amended by s 1(c) A 69/90 with effect from 1.2.1991, see Schoeman op cit at 10-204A.

497 Sec. 440F(2)(a)(ii).

498 Jooste op cit at 594.

relevant markets for that security).'[499] This seems to have broadened the spectrum of acceptable modes of publication[500] compared to the former legislation.

The last required element by the law is that the information is price-sensitive. For the purpose of s 440F this condition is met when 'it (ie the information) would reasonably be expected to affect materially the price of such security, if it were generally available'.[501] This appears to be the same requirement as in the former s 233, even though the word 'expected' in s 233 was not qualified by the word 'reasonably'.[502]

II. Some important changes to the old law concerning the definition of 'information'

Unlike the former s 233, the new definition recognises the need to provide for effective dissemination of inside information, and to give outsiders an opportunity to digest the information, a recognition which was not reflected in the formulation of the former s 233.[503]

In particular it has to be noted that, while an insider could perhaps avoid commission of the offence in s 233 by, for example, publishing the relevant information in an obscure part of some minor local newspaper or on a radio programme of limited appeal[504] in the early hours of the morning, such dissemination would clearly not meet the criteria laid down by the new s 440F.[505] Furthermore, under the old legislation, it would have been possible for insiders to arrange for orders to be executed shortly after, or

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499 Sec. 440F(2)(b).

500 Jooste op cit at 594.

501 Sec. 440F(2)(a)(iii).

502 Jooste op cit at 595.

503 Jooste op cit at 593; see also Jooste op cit (Businessman´s Law) at 249.

504 For a detailed criticism of the old s 233 see Rider (!977 SALJ) at 445. Yet, one could have argued that the words 'publicly announced' encompasses at least a means of communication that is likely to be received by a significant number of interested persons, even though it was doubtful whether this reading would stand up to a proper examination, cf Rider, idem at 445.

505 Jooste op cit (1990 SALJ) at 595; see also Jooste op cit at 249.

instantaneously with, publication of the information.[506]

Yet, the old s 233 offered a fairly clear indication of how the term 'unpublished' has to be interpreted, in that it formulated 'on a stock exchange or in a newspaper or through the medium of the radio or television'. The new Act does not require publication in any particular manner, and thereby introduces the test of general availability.[507]

On the other hand, it is no longer necessary to prove that the accused dealt 'in any way to his advantage, directly or indirectly' as was stipulated in the old s 233 although that was a very broad[508] approach.

Whereas 'price-sensitive' information under s 233 of the old Act had to relate to 'a transaction or proposed transaction of the company or of the affairs of the company', it will furthermore fall under the legislation if it relates to '... affairs of a company or its operations, assets, *earning power* '[509] or ...[510].

Jooste[511] raises the question whether by means of the inclusion of 'earning power' market information is brought within the scope of s 440F which was not the case under the old legislation.[512] This issue will be discussed below.

Moreover, s 233 merely spoke of information which, if published, 'may be expected to affect the price of the shares', without clarifying the matter any further.[513] The new provisions define this element of the offence in a much more detailed manner. Whether these details do actually help defining the

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506 Jooste op cit at 593.

507 Jooste, idem at 594.

508 Rider op cit at 444 posits that this interpretation would cover a situation where the insider dealt on behalf of someone whose profit as a consequence would yield some financial advantage to the insider.

509 My emphasis.

510 Sec. 440F(2)(a)(i).

511 Op cit at 594 et seq.

512 But see Rider op cit at 444 who said that market information would seem to be included. With respect, this must be due to an interpretational error. The issue arises under the new South African law and is again far from being clarified. The scope of the old Act, however, was certainly narrower in this respect.

513 Luiz op cit at 329.

scope of the crime is an issue that merits further analysis.

III. Analysing the elements of the definition

We shall now consider the individual elements of the definition of inside information more closely. It is important to bear in mind that insiders not only deal on positive company news, but to an even larger extent on negative data in order to avoid losses on publication.

1. Information in respect of a security

The first issue to be considered is the content of insider information for it to fall within the scope of the legislation. Irrespective of any legislative requirements with regard to publication, if the information does not fall within the scope of the insider dealing provisions, then anyone would be permitted to deal on it, whether or not the news was important.

a) What must the information relate to?

The South African insider trading law provides a list of matters to which the information must relate, if it is to be included within the prohibition. As we will see below, this is neither the case in the English nor in the current German insider trading provisions.

aa) 'Internal affairs' of the company

First, information can relate 'to matters of the internal affairs of a company or its operations, assets ...', cf s 440F(2)(a)(i). 'Internal affairs' includes both 'operations' and 'assets', and is thus the generic term referring to both. The following events and affairs are within this definition:

- A breakthrough in a technical development or in that of a new drug or medicine; a large sale of goods; a major strike in mining operations; a bank´s maintanance of a credit line when the company is in financial trouble.

- A medicine, drug or technical article proving to be faulty or defective and having to be recalled from the market; a declaration of insolvency.[514]

The following also have to be regarded as potential insider information:

- The appointment of important personalities to the board of directors; changes in capital, the issuing of new shares or debentures.

- Information contained in the annual balance-sheet and in earning announcements (both types of information applying also to combined companies), and dividend announcements.

This list is not intended to be complete but gives at least an overview of some of the events to which those occupied with the detection[515] of insider trading can relate abnormal movements in share prices or specifically high trade volumes to possible events.

bb) Affected transaction or proposed affected transaction

The terms 'affected transactions' and 'proposed affected transactions' are intended to include fusions and mergers. It is submitted that they also encompass processes of decombination and demergers because they are the 'actus contrarius' of mergers and have an equally important effect on the capital structure of the company. Unlike the old s 233, insiders both of the offeror and the offeree company fall within the legislation.[516] Taking into account the definition of 'affected transaction' in s 440A, the acqusition of substantial positions in other (stock) companies by either a company or a natural person is also within the legislation.

cc) Is 'market information' included in the term 'earning power'?

At first sight, 'earning power' would seem to form part of the internal affairs of a company since it relates to the dynamics of internal

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514 Remember that insiders are very likely to sell before the announcement of negative news, Seyhun op cit at 176 who provides empirical data for this finding.

515 In Germany detection is effected via 'Sima' (ie System zur integrierten Marktanalyse which allows an analysis of all price and turnover figures, cf FAZ 17.5.1995 'Fünf Börsen überwachen mit Sima'.

516 But see Rider at 444 '... or information that another company intended a take-over bid would seem to be included'. His interpretation is incorrect because s 233 was limited to 'information concerning a transaction ... of *the* company' (my emphasis).

development or the building up of earning facilities such as new machines or a new product series in a competitive market.

The term 'earning power' could also be interpreted so as to include affairs external to a company. Since 'earning power' is also affected by measures external to the company, this element could bring market information within the scope of s 440F.[517] Market information is data about the market for a company's securities rather than about the company itself.[518]

Take, for example, the information that the government proposes to re-open trade links with a specific country, a fact which can significantly increase the market for a particular company's product.[519] One must bear in mind that, if such situations were covered by the term, this would bring about a major extension of the regulation of insider dealing,[520] in that political issues, exchange rates, or changes in the prices of raw materials could fall within the legislation - thus extending also the scope of possible insiders. We shall see later that the European insider trading laws provide a fairly comprehensive list of examples of such 'market information'.

The problem here is one of interpretation of the statutes. As statute law is deemed to be a reflection of coherent and logical thought,[521] it is appropriate to start with the formulation itself. A textual argument in favour of including market data is that the list in s 440F(2)(a)(i) is formulated disjunctively ('or'), indicating things of a different nature.

Firstly, we have already seen that 'operations, assets' although expressed disjunctively are two features of the generic term 'internal affairs'. 'Earning power' is not separated by a disjunction but, on the contrary, is mentioned in the same line as operations and assets. Therefore, it would seem more logical to interpret it in the same way as the two aforementioned terms.

Secondly, the section runs 'internal affairs of *a* company or *its* ... earning

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517 Jooste op cit at 595.

518 Branson, 'Insider Trading-II', 1982 Journal of Bus Law 413 at 414; cf also Jooste op cit at 594 et seq.

519 Jooste, idem at 594.

520 Jooste, idem at 595.

521 Devenish, 'The nature of legal reasoning in the interpretation of statutes', (1991) 2 Stell LR 224 at 225.

power' and also 'information, in respect of *a* [522] security'. All this restricts the relation of the information to a single company. It is, however, the very nature of market information, that it is related to more than one security (or company), if not, as for example political decisions, to the market as a whole.

But no section should be interpreted without taking into consideration its surroundings, in particular the intentions of the law.[523] The mischief rule, for instance, demands that one bears in mind what sort of mischief the legislation intended to ban.[524] Applying this rule one could come to the erroneous conclusion that, wherever one is confronted with a problem of mischief, there is space for an extensive reading ie analogous interpretation.

However, there are certain limitations to such an approach. The insider prohibition is part of the statutory criminal law of South Africa and its interpretation is therefore bound by the principle of legality[525]. The principle of legality implies that the legislature ought not to create crimes with a vague content, although there is nothing to prevent the South African parliament from doing so[526] (the new South African Constitution may have changed that, but it seems too early to take such a change for granted, and as yet there is still no case law). The least we can say is that the South African courts may interpret an ambiguous criminal provision quite strictly according to the letter of the law, and thus interpret it in favour of the accused.[527]

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522 All emphases are mine.

523 See Cockram, 'The interpretation of statutes', 3rd edition, Cape Town, Wetton, Johannesburg, 1987 at 44 et seq.; What the legislature meant to say neither the court nor anyone else can tell ... . The intention must be deduced from what the legislature has said, not arrived at by conjecture of what the legislature might or ought to have meant, Wessels J in Seluka v Suskin & Salkow 1912 TPD 258 at 265 et seq.

524 Cockram, idem at 48.

525 See R v Marais (1889) 6 SC 367; R v Forlee (1917) TPD 52; S v Solomon (1973) (4) 644 (C); S v Smith (1973) (3) 945 (O); S v von Molendorff (1987) (1) SA 135 (T) 169 et seq.; see for the elements of this principle Snyman, 'Enkele opmerkings oor die legaliteitsbeginsel in die strafreg', (54) THRHR 1991 at 629-635.

526 Snyman, 'Strafreg (Criminal Law)', 3rd edition 1992, sub 'Die legaliteitsbeginsel' at 33-49.

527 Snyman, idem, quoting Moss v Sissons 1907 EDC 156 at 157; Ackermann 1931

One consequence of that rule is that analogous interpretation is not allowed.[528] A good example of this is provided by S v Smith[529], where the accused was acquitted because the court refused to extend the scope of the provision (in that case prohibiting the possession of indecent photographic matter) so as to include photostatic material in the possession of the accused. There should be a high degree of rigidity in the definition of crimes;[530] in case of doubt, an act should rather fall outside the scope of the actus reus of the crime. Consequently, since the law did not clearly include market information, dealing on such data is not within the scope of the insider trading prohibition.

Moreover, the starting point for the analysis of market information is always the data about the trades (eg volumes, options, identities of buyers or sellers) in a particular security.[531] But none of these are related to the 'earning power' and can therefore not be included. Consequently, it would seem that the issue of including market data was not raised by the South African legislator.

Since there is, with regard to the interpretation of statutes, a presumption in favour of applying statutes in their more obvious meaning,[532] it must be assumed that market information is not within the scope of the 1990 Act.[533]

b) 'Confidential' information?

With regard to the scope of inside information we must consider one further question, namely, whether the information has to originate from a relation of trust and confidence. Recently, in Knox D' Arcy Ltd & Others

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OPD at 69; S v Sachs 1953 1 SA 392 (A) at 399-400; and S v Stassen 1965 4 SA 131 (T) at 134.

528 Snyman, idem at 31 et seq.

529 1973 3 SA 945 (O).

530 Schreiner JA in S v Sibiya 1955 4 SA 247 (A) at 256.

531 See infra, group (v); see also below, chapter 4, 'offences and defences' in the English insider system which provides certain defences when the insider dealt on the strength of such market information, and it was reasonable for someone in his position to do so (cf Sched 1 to the CJA 1993 Part V).

532 Devenish op cit at 225 quoting MacCormick, 'Legal reasoning and legal theory', (1978) at 207 et seq.

533 This is also the opinion expressed in the King Tast Group Report at 8.

v Jamieson & Others[534] the problem of different classes of confidential information was raised.[535]

English courts allow an equitable remedy on the broad premise that he who has received information in confidence shall not take unfair advantage of it.[536] Therefore, in the English Law we need to consider the protection of confidential information as one possible remedy against insider dealing.[537] In Harvey Tiling Co v Rodomac[538] it was decided, however, that the 'action for breach of confidence' in the English law is not available in the South African law of trade secrets.

In South African Law protection of confidential information may be based upon breach of contract.[539] Thus, if the relevant information is truly of a confidential nature (ie it is treated confidentially and known to a closed circle)[540], it can be protected as a trade secret.[541] This distinction is clear-cut and helps identify the different qualities of inside information and trade secrets, the latter protected as a proprietory interest, the former not to be misused at the detriment of other participants on the capital markets.

Some information relating to the 'internal affairs' of a company, such as

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534 1992 (3) SA 520 (W).

535 Cf Pistorius/Visser, 'Confidential information and the danger of confusing classifications', (1993) 5 SA Merc LJ 330.

536 For example Seager v Copydex Ltd 1967 2 All ER 415 (CA) at 419; it should, however, be noted that it is sometimes difficult to determine what actually was confidential and what not, see Joubert, 'Die reg en inligting', (1985) 18 De Jure 34 at 42; see also Pistorius, 'Confidential information and the rights of employees', (1993) 1 Juta´s Bus Law 133 who argues that 'confidential' information is information not known to the general public.

537 Rider, 'Abuse of inside information', (1977) 127 The New Law Journal 830 at 832 who is of the opinion that the confidentiality of the information was an essential requirement for insider dealing.

538 Cf Harvey Tiling Co (Pty) Ltd v Rodomac (Pty) Ltd & Another 1977 (1) SA 316 (T); cf Pistorius/Visser supra note 270 at 331.

539 Pistorius/Visser, idem at 331.

540 Cf Harvey Tiling v Rodomac op cit at 323 and 325.

541 See Pistorius/Visser op cit at 344; see also Havenga, 'Company directors - fiduciary duties, corporate opportunities and confidential information', (1989) 1 SA Merc LJ 122 at 123.

production costs or trade secrets, which is treated as confidential information, can at the same time constitute inside information. The question is, however, whether inside information is necessarily confidential. Under the old s 233 it was not necessary for the insider to have obtained the information in the course of his office or through it.[542] Since inside information under the new s 440F can even be obtained through 'theft', it is evident that no relation of trust and confidence would need to pre-exist between the insider and the company. Thus the confidentiality of the information is no relevant criterion for the South African insider trading prohibition.

2. 'Unpublished' information

While the 1973 Act imposed liability only on insiders as defined in s 229[543], the 1990 Act imposes liability on persons more or less generally. It seems therefore, that prohibited is no longer *insider* trading, but rather *trading on inside information* .[544] Because of this it is very important to define clearly and thoroughly the term 'information' as the key element in the definition the offence.

The information has to be 'unpublished', cf s 440F(2)(a). According to the capital market mechanisms examined in Part I, information is reflected in share (and option/future/debenture etc.) prices immediately after the release of the new data. This element is therefore central to the definition; it is directly opposed to the term 'inside'.

a) Generally available

Unlike the old s 233, the new Act does not require the information to have been published. Rather the information needs to be incorporated in the (resonable) investor´s decision to buy, to hold, or to sell. The time which has elapsed after the publication is difficult to determine, because every piece of information is different. Thus, although broadening the spectrum

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542 Criticised by Rider op cit at 444.

543 Sec. 229 of the old Act, as amended, eventually repealed by s 6 of Act 78 of 1989 with effect from 1 February 1991, cf Henochsberg on the Companies Act, 5th edition, edited by Philip M Meskin, Durban, 1994 at 443.

544 See Luiz op cit at 330.

of acceptable modes of publication, each case must be resolved by the courts on the basis of a 'resonable investor' test to see whether the particular method of dissemination suffices.[545] Jooste[546] argues that this is an objective 'resonable investor' test. But the objectivity of the test is not so obvious.

Textually, the 'investor' in s 440F(2)(a)(ii) is the reasonable investor '[only][547] in the relevant markets for that security'. This formulation is quite different from the view taken by US courts when defining, for instance, the price-sensitivity of the information. In the cited cases the 'reasonable man' or 'reasonable investor'-concept is never limited to refer only to investors in relevant markets for the security.[548] This is important because some shares are very rarely or not at all sought by the normal investor, but only by professionals who, according to their skills and information systems, will have absorbed the information more rapidly than the average investor - who normally puts his money in blue chips anyway. Also, it is evident that insider trading is at times more likely to occur in lesser capitalized firms.[549]

The objectivity of the test can therefore only be a relative objectivity. It is submitted that the test that ought to be applied is a combined subjective-objective test. It should be subjective insofar as it concerns the group of investors who normally constitute the market for the security (securities/companies) to which the information refers - and objective insofar as this group´s normal standard of absorbing news of a similar kind is concerned. This interpretation guarantees more certainty for the investor, while mainting a reasonable degree of flexibility at the same time. It should be provided that, as soon as the Johannesburg Stock Exchange becomes capable of incorporating new information more quickly in securities prices,

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545 Jooste op cit at 594.

546 Idem at 594.

547 My addition.

548 See TGS op cit note 1 at 849: 'facts which, if disclosed, would be reasonably likely to have a substantial market effect'. See also TSC Industries Inc v Northway, Inc (1976) 426 US 438 at 449. In this decision the US Supreme Court held that inside information included inferences which a reasonable investor would draw from facts in his possession.

549 Schäfer/Ott op cit at 228 et seq.

the time which has to elapse after publication is reduced [550].

Nevertheless, this subjective-objective test may sometimes cause uncertainty and thus create a dilemma for potential dealers.[551] The definition contained in the 1990 Act leaves it to the courts to decide whether or not sufficient steps had been taken, and sufficient time had elapsed to allow the conclusion that the information was generally available when the accused dealt on the basis of such information.[552] The flexibility can be mitigated only by applying this subjective-objective test which demands careful consideration in each case of both new data and relevant market for the security concerned.

b) Time to 'digest' the informational contents

The information need not be generally known. It is sufficient that it can be reasonably expected that it is known, or *should*[553] be known to the investors. This is indeed an objective element. But it still gives the courts enough discretion to decide whether 'such steps have been taken *and*[554] such time has elapsed'. The emphasis is added to make it clear that both demands must be satisfied. Even in cases where all publishing requirements are fulfilled by a company the insider who deals may still commit an offence.

This 'digestion time' for the information is part of the element of general availability. This seems to be an important issue for the South African legislator. Sec 440F(2) of the 1989 Act intended to restrict dealing for 24 hours after the announcement of the information.

In any event, the time limit effectively placed insiders (and tipees) at a disadvantage, because other traders were able deal as soon as the information became known to them.[555] This is also true for the definition in

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550 See Bhana op cit at 206: 'However, these results do not support the semi-strong form EMH since the market reaction to new public information continues for a period of five trading days after the announcement.'

551 Jooste op cit at 594.

552 Luiz op cit at 331.

553 My emphasis.

554 My emphasis.

555 See comments on s 440F of the 1989 Act, for instance, Luiz op cit at 331.

the new s 440F. The uncertainty which the formulation creates among potential insiders serves to keep them away from the markets. It would seem, however, that their abstention reduces market liquidity, thus bringing about an economically inefficient result. In this respect it is doubtful whether the definition contained in s 440F is in line with modern economic and share price theory.

c) Interim remarks on the concept underlying the South African provisions on insider trading

We shall pause here and contemplate for a moment the rationale of the provisions. As mentioned above, the 'fraud' requirement of the 1989 Act was abandoned. Yet the US American philosophy of investor protection still shines through in the provisions. According to the US position, information is 'material' where there is a substantial likelihood that the information will change the 'total mix' of the information available to the investor.[556] Thus the scope of the definition turns upon the need to protect the investor in the relevant market. The same is true for the publication requirement in the South African provisions. It is not defined at precisely which moment the information can be deemed to 'have been made public'.

It will be the task of the courts to trace, depending on the facts of each case, this moment in relation to the investors who are supposed to carry out or to have carried out transactions in the affected securities. Whenever the investors tend to react rather late upon the release of new data, the information will remain 'unpublished' in terms of s 440F(2)(a)(ii) and (b) even longer than the 24 hours of the 1989 Act.

All this effort is made to enhance investor protection at the expense of possible insider traders. They incur an increased risk when dealing around the time of publication. The investor is thus pictured as an individual person expressing his wish for self-determination also in investment decisions. His free will is to be protected against lack of information upon which his decision is based. The underlying philosophy of the South African law on insider trading is the protection of individuals.

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556 See Basic v Levinson, 108 (S Ct) at 983; see also TSC Ind v Northway, Inc 426 US 438 (1976) at 449.

d) Particular problems concerning the publication element

As noted above, the courts have to decide whether any particular method of dissemination suffices. After an examination of the basic rationale of the law, it should be possible to deal with some particular problems of the definition in this regard.

aa) Is it sufficient to inform the shareholders?

The shareholder needs to be informed about his company. This can happen through posting of annual statements, or placing information before the annual meeting, or through lodging of information with the Registrar. The question which has to be dealt with here is whether or not these ways of informing the shareholders are sufficient to meet the requirements of the publication element. In other words, is the information published if the shareholder is informed through either of these ways?

Jooste[557] considers that the legislature should have been more specific in this regard. The purpose of such annual statements is certainly to keep the shareholders duly informed about their company. These statements do not, however, serve the interests of potential investors in the capital markets. Investors need timely disclosure for investment decisions rather than information about past events (as is the case in these statements).

The main purpose of the publication requirement in the insider trading context is to facilitate (quick) investment decisions for outsiders, and thereby reducing their risk of suffering losses from insider trading. Annual statements cannot serve this purpose, because they are published too late.

Annual statements are sent only to shareholders, not, however, to any potential shareholder, nor to the market as a whole. The purpose of the publication requirement in the insider trading prohibition is to inform all market participants. With regard to price-sensitive information, the capital markets must take priority over the shareholders because the market is the place where funds are raised for future investments. Moreover, the capital market is the place where insider dealing occurs, and where the ordinary investors (including those who are not yet shareholders) need to be protected. Therefore, no single information can be 'public' which is not available to the participants in the capital market.

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557 Op cit at 594.

The same applies to information lodged with the Registrar. No lodgement of information with the registrar, in terms of s 9(1) of the 1973 Act is made early enough for the information to become 'public' in the sense of the insider trading provisions.[558] Neither posting of the annual financial statements of a company in which price-sensitive information is disclosed to shareholders, nor the placing of such statements before the annual general meeting, is sufficient publication for the purposes of s 440F.

bb) Ticker tapes and financial journals

Another question is whether it would be sufficient for the information to be disclosed on a ticker tape. In a well-functioning market the informational process through Stock Exchange tickers is very relevant in the daily practice of professional participants. Professionals such as financial intermediaries should be informed as soon as possible by the comanies. The most used medium for them is the ticker fed by Reuter, DPA and other international news information systems. One would therefore expect that information which is available on ticker is treated as duly published.

Yet, here again, we should distinguish two phases in the information process. The first takes place when information is passed on to Reuter or another system. This does not yet 'make' the information 'public', though. The same (ie that it does not meet the publication requirement) is true for the formulation 'such steps have been taken' or 'such time has elapsed', because the information at that stage is not publicly available.

The second phase takes place when the information comes in on the ticker. New data is incorporated into the share price only after that phase. From this moment onwards the information can be regarded as having been 'made public'. However, the South African legislation decided otherwise. As was suggested above, the underlying concept of the South African insider provisions is that the individual investor needs even more protection. Since the tickers are available only to professionals such as banks, brokers or dealers, the individual still needs to be granted time to 'digest' the information. Hence, publication through ticker is not sufficient for the information to be regarded as 'published' under the present South African insider trading prohibition.

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558 Jooste op cit at 594 raises this question.

Yet there seems to be one exception: once it is accepted that 'made public' has to be defined in relation to the relevant groups of investors, information is 'published' as soon as it is available on ticker tape, provided that the security is traded only by professionals because it 'can be expected to be known to such an investor'.

cc) The language problem in South Africa

In South Africa there is also the issue of different official languages. In which language or languages does the information need to be published for it to meet the requirements of the insider trading provisions. South Africa now counts no less than 11 official languages. The first question is whether publication in any one of the official languages will suffice.[559] Jooste[560] raises the question whether publication in a black language should not also be necessary, particularly considering the fact that the share-incentive schemes of some large listed companies have resulted in considerable numbers of black shareholders.

It is necessary here to reconsider the underlying concept of the law. Investor protection demands that the shareholder in the *affected* security should reasonably be expected to be aware of the information. The decision in which languages the information needs to be published in order to fulfil the publication requirement will depend on the 'relevant markets' of the shares. This introduces yet another element of subjectivity. Undoubtedly, this adds to the uncertainty already created by the vagueness of the definition. Yet, bearing in mind the underlying philosophy of the South African insider prohibition (ie maximum small investor protection), this meets the rationale of the law. Where securities of a company which has black shareholders are affected, the information must also be published in their language. If not, the necessary steps to 'make the information public' have not been taken. It is a consequence of the ratio legis that, by dealing around the time of publication of new data, the insider will incur the risk of contravention. The concept may be criticised but it was chosen by the legislation.

Nevertheless it is suggested that for the information to be 'made public', it ought to have been published in English, too. In spite of all the recent

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559 Jooste, idem at 594.

560 Idem at 594.

political developments in South Afria, it still seems that English is the prevailing language in commerce and economics in general. Moreover, we can observe a tendency which is that a growing number of people are reaching a higher level of education, resulting, amongst other things, in an increased spread of English. Taking this into account it seems reasonable to demand publication also and generally in English.

3. Price-Sensitivity

The final element of the definition is that the information must be price-sensitive. Sec. 440F(2)(a)(iii) requires that it 'would reasonably be expected to affect materially the price of such security if it were generally available'.

At first sight, it seems that there is nothing in the 1990 Act to help the prospective investor decide whether information is price-sensitive or not, and whether such information would materially affect the price of the securities.[561] Yet this is an important issue: depending on what is required by the element of price-sensitivity the scope of this information that falls within the legislation will eventually be defined. Therefore it would only seem fair to give insiders some clearer instructions as to when they will incur the risk of contravention.

Sec. 233 of the old Act did not qualify the word 'expected' by the word 'reasonably'. This was criticised because the provision did not indicate whether the test of materiality was an objective or a subjective evaluation.[562] The word 'reasonably' connotes an objective standard.[563] We should raise the question of whether this objectivity is related to the relevant market, ie the investors who normally trade in the affected security, or whether this is a 'reasonable man' approach similar to that prevailing in the US insider law.

As has already been suggested, the publication requirement of the insider trading prohibition needs to be interpreted in relation to the normal investor in that security. This interpretation serves as a means of limiting the risk (or at least to make it easier to calculate) which insiders must incur

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561 Luiz op cit at 330.

562 Rider op cit at 444.

563 Jooste op cit at 595 thinks that this is the same as under s 233 of the old legislation.

under the South African provisions.

With regard to the price-sensitivity element of the definition it must be borne in mind that the information is relevant to the market as the whole. On release of new company data all investors are called to revise their previous investment decisions. This informational process is at the very heart of the allocative functions of the capital market. Therefore, it is more appropriate here to refer to the investors at large so that the price-sensitivity of the information has to be evaluated through the eyes of a reasonable investor. Only this form of an objective test is in line with the South African concept of investor protection, and the rationale to enhance decisions taken by free and informed individuals.

Jooste[564] quoting Gore-Brown[565] thinks that it is not enough for the information to be likely to influence most investors in arriving at a decision whether to buy or to sell the relevant security, if it is not also likely materially to affect the market price. The price effect and investor reaction are but two sides of the same coin. Without a majority of investors changing their mind about the evaluation of a security, the price of that security is hardly likely to change at all, because the share price is economically conceived to balance heterogenous expectations on *future* income streams.[566]

It has further to be noted that it is enough that the information is *likely* to influence the market price. It is therefore not necessary to prove that the price did *actually* change on release of the information.[567] The actual price shift can be a matter of hindsight only to a very small extent. This is in line with modern economic theory because, when insider trades occur, most of the price shift is very likely to take place already *before* the publication.

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564 Idem at 595.

565 Op cit at 12.19.9.

566 See Schneider op cit at 1433 et seq.

567 The emphases are mine.

IV. Evaluation of the South African definition

The South African definition of what constitutes 'inside information' is based on a rationale which aims to reduce the systematic risk of non-informed investors being outperformed by insiders who make use of (institutional) informational imbalances. Clearly, the intention of the law is to strengthen investor protection.

In order to achieve this, the law provides a list of potential inside information. This list is sufficiently comprehensive to include all relevant internal company data. Since the information does not have to be confidential, the definition could also include market data. It is submitted, however, that market information is not caught within the scope of the definition. If such data are really a relevant source of losses to insiders, this gap is to be regarded as a shortcoming.

The scope of the 'insider'-definition is far less important than the definition of 'trading on the strengh of' inside information. Inside information is the key element of the offence. It is therefore all the more regrettable that not enough light has been shed on the question of when information is 'inside'.

The central element of all inside information is that the information is non-public. Consequently, it would seem imperative for the law to be particularly meticulous when defining the criteria required for this element. However, both the means of publication and the time which must elapse after the publication are largely left open to the discretion of the courts. The same is true for the application of these requirements in terms of a 'resonable investor' test. It is submitted that such formulation will create a high degree of uncertainty for potential dealers.

Not only could this prove to be a deterrent for insiders, but also for professional dealers which will cause a negative effect on trading volumes and hence on market liquidity. In this respect both former versions, ie the 1973 Act (ie published equals made public) and the 1989 Act (ie published plus 24 hours equals made public) offered more clearcut definitions.

One has to be sceptical as to whether the discretion given to the courts will make things easier, or stimulate activities which are important for market liquidity. It is suggested that it would have been better to stick to the clearcut older texts. A modern approach would also have taken the mechanisms of market efficiency more into consideration.

The 'digestion time' provided for in the new provision is unclear and therefore not valuable. Such an element is also not in line with modern economic knowledge about the incorporation of news into share prices. A well-functioning market and its mechanisms provide more investor protection than does a ban on insiders, particularly, if this ban is so vaguely shaped that it becomes a deterrent for innocent trades.

It is submitted that the definition which is originally based on the idea of investor protection will turn out to be a hindrance for market efficiency and thus be counterproductive also in terms of investor protection.

Even if insiders carry out their transactions at the expense of other traders, no loss will occur to an outsider from the moment in which the price has adjusted to the new informational situation. It would therefore have been preferable to define the moment of publication according to the price adjustment process. But the South African insider provisions do not allow for an interpretation that 'such time has elapsed' (ie the information is 'public') when the price of the security reflects the new information. Only this would take into account both modern economic theory and investor protection, for when information is reflected in the share price, it becomes impossible for the insider to profit from this information.

Instead, for the information to be public it must be expected to be known to the 'reasonable investor', whoever he might be. Thus, not even information published in accordance with all regular publishing requirements can safely be regarded as 'made public' in terms of the insider provisions. For the intended investor protection it is irrelevant whether or not the investor knows the information, as long as the price is 'correct' (ie it reflects the current supply of information).

The definition of 'inside' sticks one-sidedly to the concept of insider dealing as a fraudulent act, and does not bear in mind the functioning of impersonal stock markets. This mistaken approach is reflected in s 440F(4)(b): there, *all* dealings are included (ie not only on stock markets). As discussed earlier, face-to-face dealings and dealings on impersonal stock markets need to be regulated in a different way.

Economically, in a properly functioning market, no investor would be likely to suffer any loss after the information has been 'published' through the Stock Exchange ticker. This aspect of price adjustment should have been taken into account by the South African legislation. At least in cases where there is no major price shift after an insider traded, it should be judged in favour of the accused. This interpretation would, as we have seen, be in line with the concept of investor protection, but it would at the same time mitigate the effect of the vagueness of the publication requirement. If the courts do not follow this interpretation, it would seem that the market loses liquidity which would constitute a major restriction for foreign investors, and this would certainly produce worse effects on the economy than some laxity in the application of the insider trading prohibition.

C. The definition of inside information in the Directive

Since the Member States of the European Union must comply with the provisions of the Directive, it is appropriate, before entering into the details of the laws of England and Germany, to examine the European definition of inside information. The Directive itself has been given extensive attention in the literature[568].

I. Starting point: the wording of the definition

Article 1 of the Directive runs:

> 'For the purposes of this Directive:
>
> 1. 'inside information' shall mean information which has not been made public of a precise nature relating to one or several issuers of transferrable securities or to one or several securities, which, if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question'.

II. Definitions and interpretation of a Directive

It has to be noted that there are no further instructions as to the meaning 'made public' or 'significant effect'. On the contrary, the definition is formulated in a very abstract way, leaving some of its main elements to the discretion of the national Parliaments. Certain parts of the definitions have a highly hypothetical character. Therefore, the national legislators had to bear in mind the importance of the preamble to the Directive. After all, the European Court would base a decision on the teleological aspects provided by that preamble.

The preamble to the Directive is based on Article 100A of the Treaty of Rome which reveals the main purpose of European legal measures, namely, that both regulation and administrative action which 'directly affect the functioning of the common market'[569] need to be harmonised in the Member States. The aim of our interpretation is therefore to provide an understanding of the text as a means of harmonising the national laws. With regard to insider trading there is also a very practical reason for doing so;

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568 See notes 447-449 above.

569 Ashe op cit (1992 Company Lawyer) at 16.

all important European companies have their shares quoted on many if not all European stock markets. It is therefore important that information relating to such companies is treated equally in all stock markets. In other words, insiders should be treated the same throughout Europe.

According to Art 189 III of the Treaty of Rome, Directives are binding *for* the Member States, not *within* them. This means that a Directive does not normally have binding effects for the people in the Mmember States. They need to be transposed into domestic law before they will be binding for individuals.[570] Art 189 III also provides that a Directive should always leave enough discretion for the Member States to formulate provisions which are appropriate to their national law systems.[571] Without leaving this 'space' a Directive may not fit into the national laws and may therefore be experienced as an authoritarian act from Brussels. Article 6 of the insider Directive, for instance, provides that 'each member state may adopt provisions more stringent than those laid down by this Directive'.

III. The elements of inside information

According to this definition information must be 'of a precise nature'. This requirement is an attempt to distinguish between rumour (or idle speculation) and hard facts.[572] The wording may raise a problem in that a narrow reading may result in the requirement that one isolated fact must have a significant effect on share prices.[573] As Ashe[574] argues, such an approach would be unrealistic. Economically, the share price is a function

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570 Bleckmann, 'Europarecht', 5. Aufl., München, Köln, 1990, at 83.

571 If complete harmonization were envisaged by the EU, it would have been necessary to adopt a regulation; for a comprehensive overview of this problem see Bleckmann op cit at 87. Since the Directive on insider dealing leaves enough space for the Member States to modify the scope of the provisions (cf Art 6), it would not seem that narrow definitions go beyond what is prescribed by a Directive.

572 See Claussen op cit at 276 who argues that such 'facts' require events which are already terminated. For the English literature see Ashe op cit at 16 who, it is submitted, correctly, argues that the term also includes information about future events. The view of Claussen excludes, for instance, a forthcoming take-over bid, an interpretation is not desirable under any insider trading regulation.

573 See Ashe op cit at 16.

574 Idem, at 16.

of all available data: it is impossible to determine the exact impact of an isolated piece of information. It would seem that the definition must be understood to cover situations where information consists of several facts which - taken altogether - cause a shift in share prices.

Another question is whether or not the insider would be guilty who had access only to some facts, and not to the complete information. It would seem that, as long as it cannot be established that those facts which the insider knew of were indeed decisive for the change in share prices, the prosecution must fail.

The second element of the definition of inside information is that such information has 'not been made public'. The basic intention of this element can be summarised as 'the aim to neutralise the normal advantage of an insider'.[575] What is questionable, however, is the degree to which this should be the done, ie how far this advantage should be equalled out. As was noted above[576], there is nothing wrong with informational advantages in general.

Some English commentators, citing the case SEC v TGS,[577] emphasise that the investors should be placed on an equal footing.[578] They suggest that the information loses its inside status only when a good faith investor acting with due care can obtain knowledge of it.[579] 'Not have been made public' can therefore not be equated with 'not yet published'.[580]

It is submitted that this view has to be rejected. As far as secondary European Law is concerned, the European Court of Justice at times applies the historic method of interpretation, ie takes into consideration the formulation of drafts of Directives. Before the insider Directive was adopted, the Commission submitted a proposal[581] and an amended proposal

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575 Idem, at 16.

576 See 'morality of insider trading', Part I, chapter 1, A, II.

577 SEC v TGS Co 401 F 2d 833, and Mitchell v TGS Co 446 F 2d 90, 103 (10th Cir 1971) cert denied.

578 Tridimas op cit (European harmonisation) at 930; Ashe op cit at 16.

579 Tridimas, idem at 930.

580 Tridimas, idem at 930.

581 COM (87) 111 final (1987) OJ No C 153/8.

for the insider Directive[582]. Those drafts defined 'inside information' in their Articles 6 as 'not generally known' (in the proposal) or as 'not accessible to the public or not available to the public' (in the amended proposal). Both formulations address the public at large and define 'inside' in terms of the general investor, which would support the approach suggested by the English commentators. It is clear, however, that this approach does not underlie the final Directive. On the contrary, these changes[583] reveal a gradual departure from the 'equal footing' approach the requirements of which would be met only by the very first wording, ie 'generally known'.

The third characteristic element of the definition is the qualitative test of price sensitivity. Information is material only when, if disclosed, its effect on the market price would be likely to be significant. The concept of materiality has an inherent vagueness, and it is difficult to provide guidance as to how substantial the impact must be in order to satisfy the test.[584] What may or may not be significant will also vary from share to share. The test proposed in the Directive may therefore be criticised as vague.[585] In the German literature the materiality-element is a significant issue because the courts' power to impose criminals sanctions is strictly limited by the objective wording of a penal statute such as insider trading prohibition.

It has to be noted that none of the elements of the definition give any further guidance as to the meaning of 'inside information'. 'Non-public', 'significant effect' and 'precise' could describe any information, and 'relating to one or several issuers or securities' appears to be relatively vague with regard to the informational contents. This is regrettable, because the Directive stipulates that companies must publish all information which may have a significant effect on the share prices has to be published[586]. This creates much uncertainty for the companies.

As we have seen above, it is not helpful to define the key element of the

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582 COM (88) 549 final (1988) OJ No C 277/13.

583 For this textual development and its impact on the interpretation of the final Directive cf Tippach op cit, Part I, chap 4, V, 3, a.

584 Tridimas op cit at 930.

585 Ashe op cit at 17.

586 Article 7 making reference to the provisions of Sch C 5(a) of the Annex to Directive 79/279 EEC OJ No L66, 16.3.1979, at 21.

insider trading provisions in rather vague terms, because in most cases insiders would exploit the same type of information.[587] Moreover, this would seem to create too much uncertainty with regard to the reach of the prohibition. The only guidance provided by the text is that the information can relate either to 'issuers' or to 'securities', thus including both company and market information.

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587 Empirical evidence shows, however, that in the USA insiders have become more reluctant to trade immediately before take-over announcements and earnining announcements, see Seyhun op cit at 173 et seq.; this effect appears to be due to relevant case-law, particularly to the Chiarella decision, 588 F 2nd 1358 (2d Cir 1978), rev'd 100 S Ct 1108 (1980), much more than to changes in regulations or an increase supply of statutory remedies, such as provided by the ITSA 1984 and the ITSFEA (1988), see Aldave, 'The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal', (1988) 52 Albany Law Review 893.
Whatever the reason may be for this finding, the present author takes the view that market participants will be satisfied with the fact that they are not outperformed on the basis of exactly this type of information, simply because it is so obvious that high profits can be gained from such information. The economic finding that insiders outperform the market on an average of 8-12%, however, would not seem to demoralize them, taking into account that they can still discount a certain percentage of the price of shares.

D. Inside information in the English legal concept

I. Overview: the elements of the English definition

The definition of the term 'inside information'[588] in the English law is long and complex and breaks down into four cumulative components. All four must be present for the information to be 'inside information'.[589]

First, 'inside information' means information which relates either to 'particular securities'[590] or to a 'particular issuer[591] of securities' or to 'particular issuers of securities'.[592] Also, information shall be treated as relating to an issuer of securities which is a company, not only where it is about the company, but also where it may affect the company's business prospects.[593] This latter provision has been criticised as extending the net too broadly.[594]

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588 This definition is contained in s 56 (1) which runs:

For the purpose of this section and section 57, 'inside information' means information which relates to

particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;

(b) is specific or precise;

(c) has not been made public; and

(d) if it were made public would be likely to have a significant effect on the price of any securities.

589 Lomnicka op cit at 176.

590 'Securities' is defined in s 54, see chapter 4 'offences and defences'.

591 Defined in s 60 (2) as 'any company, public sector body or individual by which or by whom the securities have been or are to be issued.'

'Company' is defined in s 60 (3)(a) to mean any body (whether or not incorporated) which is not a public sector body, wherever incorporated or constituted, thus covering foreign bodies (as was the case under the 1985 Act). 'Public sector body' means (i) any government, (ii) any local authority, (iii) any international organisation the members of which include the UK or another Member State, (iv) the Bank of England or (v) the central bank of any sovereign state, cf s 60 (3)(b).

592 Sec. 56(1)(a).

593 Sec. 60(4).

594 Hannigan op cit at 60.

In the parliamentary debates it was said that the provision embraced almost everything, from information which had only an indirect bearing on the business to activities of competitors, industry trends and the state of the economy in general.[595] In particular, investment analysts would be drawn further into the legislative net, since any briefings were likely to include information about the company´s business prospects which may in turn affect the prospects of other companies in the same sector.[596] The Treasury argued, however, that the code against insider dealing could not be effective unless it applied to dealings on the basis of information about business prospects, which is highly price sensitive with respect to certain companies´ securities, but does not relate to the companies themselves.[597]

Sectoral or other information stemming from outside the company may be better referred to as 'external' or 'market' information. Since the final draft of the Directive, it has been a question whether the European law would encompass such information. We shall turn to this problem below when dealing with 'government data' and 'market information'.

Secondly, in order to be included in the definition, the information has to be 'specific or precise'. The need to establish possession of specific or precise information represents an amalgam of the Directive´s use of the term 'precise' and the retention of the word 'specific' of the 1985 Companies Securities Act[598]. This element of the definition has been expressed disjunctively, but the distinction is not readily apparent, for neither term is defined elsewhere in the legislation.

Thirdly, the information must not have been 'made public'. Sec. 58 is devoted to spelling out the meaning of this phrase, stating that its provisions 'are not exhaustive with regard to the meaning of that expression'[599].
The information is 'made public', if any one of the four situations enlisted in s 56(2) of the Criminal Justice Act (CJA) 1993 (Part V) is present. These are that the information: is published in accordance with the rules of

595 HL Debs, vol 540, 3 Dec 1992, col 1495.

596 HC Debs, Session 1992-93, Standing Committee B, 10 June 1993, cols 196-197; see also Hannigan op cit at 60 et seq.

597 Treasury commentary on the original draft of the Criminal Justice Bill (Oct 1992) para 15.

598 Wotherspoon op cit at 421.

599 Sec. 58(1) CJA 1993.

a 'regulated market'[600] for the purpose of informing investors and their professional advisors[601]; or is contained in public records, ie in records which by virtue of any enactment are open to inspection by the public;[602] or can be readily acquired by those likely to deal in any securities;[603] or is derived from information which has been made public[604].

To complicate the matter further, s 58(3) of the CJA 1993 then lists five circumstances when information *may* [605] still be treated as 'made public' despite the circumstances. This wording appears to give the courts large discretion, depending on the facts, to decide one way or the other.[606] Four of these circumstances are relevant.

The first two of these circumstances are that the information: can be 'acquired only by diligence or expertise';[607] or is communicated to a 'section of the public and not to the public at large'[608]. The use of the latter phrase suggests that it is not enough to communicate the information to a group with a common characteristic, eg a group of analysts. The group has to be representative of 'the public'.[609] Moreover, the information may be treated as 'made public' when it can be 'acquired only by observation'.[610]

The two further circumstances where the information 'may' be treated as public are that the information: 'is communicated only on payment of a

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600 As defined in s 60(1) of the CJA 1993.

601 Sec. 58(2)(a).

602 Sec. 58(2)(b).

603 Sec. 58(2)(c), meaning securities (i) to which the information relates or (ii) of an issuer to whom the information relates.

604 Sec. 58(2)(d). This is directly derived from the Preamble to the Directive which stipulates in the last but one paragraph that 'estimates developed from publicly available data cannot be regarded as inside information and ... any transaction carried out on the basis of such estimates does not constitute insider dealing ... .'

605 My emphasis.

606 Lomnicka op cit at 178.

607 Sec. 58 (3)(a). This alternative is questionable because it appears to open a special defence to particularly skilled persons like investment bankers who are often involved in insider trading.

608 Sec. 58 (3)(b).

609 Lomnicka op cit at 178 fn 55.

610 Sec. 58 (3)(c).

fee'[611]; or is published outside the United Kingdom.[612] Fears were expressed in Parliament that the last part of the provision might enable potential insiders to cause the publication of the information in an obscure foreign newspaper and thus provide them with a defence.[613]

Fourthly, in order to qualify as 'inside information', the information must, 'if it were made public be likely to have a significant effect on the price of any securities'.[614] The use of the adjective 'significant' means that the information must potentially have a major impact on the price. Potentially trivial movements in price are not enough.[615] The price impact of information is, however, very hard to predict because it depends on several variables such as the liquidity of the company´s shares and the prevailing general market conditions.[616] The Stock Exchange´s recent consultative paper on the subject concedes[617] that it is impossible to formulate an exhaustive definition of 'price-sensitivity'. This dilemma also occurred in Germany and has been given attention in the German literature.

II. Comparison to the former law

It is necessary to pause for a moment to compare this new definition of inside information with the former English law because the comparison will further clarify the contents of the new statutes.

Under the 1985 Companies Securities Act (CSA)[618], too, in order to commit the offence of insider dealing, it was necessary for the individual

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611 Sec. 58 (3)(d).

612 Sec. 58 (3)(e).

613 See Lomnicka (1994 Journal of Business Law) at 178 fn 58. This fear was particularly relevant under the former South African insider dealing provisions, see Rider op cit (1977 SALJ) at 445.

614 Sec. 56 (1)(d).

615 Lomnicka op cit at 178.

616 Wotherspoon op cit at 424. Other variables could be: market liquidity, ways in which the information is released (newpaper headline or rgular information with the Registrar), or sectoral information.

617 London SE, Consultative Document on the Dissemination of Price Information (nov 1993) at 6.

618 For an excellent cmprehensive overview of the old provisions see Gower,

concerned to have 'information as an insider'.[619] The onus was on the prosecution to prove that this was the case. An insider was either 'connected with a company'[620] or worked as a 'public servant'[621].

Without a detailed interpretation by the courts the following were looked upon as price sensitive inside information: advance knowledge of an imminent take-over; knowledge of a forthcoming placement of new shares in combination with the implementation of a financial recovery programme;[622] knowledge of a significant change in the investment policy of a unit trust; change in the structure of a specialised energy trust[623].

According to the definition of inside information in the 1985 Act, the information had to be held by an insider by virtue of his position, and it had to be information which it would have been reasonable to expect a person in that position not to disclose, except for the proper performance of his duties.[624] Moreover, the information had to be non-public and price-sensitive, two elements which remained the same in the new provision but which were less carefully moulded in the old Act.

1. Confidentiality of the information

The word 'confidential' did not appear in the old Act, but was regarded as a fair summary of the Inside Dealing Act (IDA)´s rquirement that the information must have been held 'by virtue of a position' and that the holder of the position would not disclose it 'except for the proper performance of his duties'.[625] It was thus clear that the IDA aimed to

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'Principles of modern company law', London, 1992 at 624-642.

619 See s 1(1)(a), (2)(a), (3)(a), for public servants see s 2(1)(a); see Rider/Abrams/Ferran op cit at 136 et seq.; for the corresponding provisions in the 1993 Act see s 52(1) (dealing), s 52(2) (encouraging and disclosing).

620 For the term 'connection' see Rider/Abrams/Ferran op cit at 136 et seq.

621 Defined in s 173(2)(a-c) FSA 1986, inserted as s 2(4) in the IDA.

622 R v Cross [1990] Cr App R 115.

623 See for these examples Tridimas op cit at 931; see also Suter, 'The regulation of insider dealing in Britain', London, 1989 at 103 et seq.

624 Sections 1(1),1(2),1(3), 2(1)(b),2 (4) of the IDA 1985.

625 See Alcock op cit at 68; see also Prentice, 'Companies Act 1980', London: (Butterworth), 1980 at 301; cf also Suter op cit at 99; for the old Act see Hannigan, 'Insider dealing', 1st edition, London, 1988 at 78.

impose liability on anyone who knew or ought to have realized that there had been a breach of confidence which allowed him to profit from that breach by dealing in corporate securities.[626]

Unlike the other parts of the definition, the test to be applied in order to establish a breach of confidence was an objective one.[627] The adoption of such a fiduciary model meant that insider dealing provisions concentrated upon the relationship between the trader and the company to which the fiduciary duty was owed, rather than upon the relationship between the trader and the other party to the security transaction or, more generally, with other traders in the market.[628]

Without attempting to evaluate[629] the old approach (ie that the element of

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626 Alcock op cit at 68; Rider/Abrams/Ferran op cit (Fin. Services Act 1986) at 137.

627 Suter op cit at 99.

628 This suggestion was made by Davies op cit at 94, although he considered the market approach offered by the European Directive. Such a way of determining the actus reus of insider dealing is not convincing. The 'relationship' between the parties involved in transactions on impersonal markets cannot be decisive where the 'affected securitie's do not imply such a relationship, for example transactions in bonds; but see Botha, 'Directors´ fiduciary duties to bondholders? Some relationships between corporate financial management and fiduciary law', (1993) 5 SA Merc LJ 287, are of a different nature, ie whether the managers owe certain duties not to engage in unexpected and risky borrowing, cf idem at 293 et seq.; or take, as a further example of a situation which does not lead to fiduciary relations, the transaction in rights (options) where such a right is traded, but not executed so that the other party never became a shareholder. Dealings in derivatives do not seem to create any fiduciary obligations at all.

629 Alcock op cit at 68, is of the opinion that, without some qualifications to Art 1(1) of the Directive, this provision endangers all securities markets, particularly those relying on a market-making system. He puts the question of how a market maker could possily make continuous two-way prices other than by reacting to every scrap of information or rumour he receives, no matter where it comes from.

Any answer to this question is related to the market-maker exemption, rather than to the conceptual approach of 'breach of confidence', because the market-maker is under no duty of confidence to a company, and can therefore only be caught as a secondary insider. It is also widely accepted in the economic literature that in most cases the market-maker suffers a loss from dealing with insiders, see Demsetz op cit breach of confidence was required), it is important to note that the concept of a breach of confidence did not become part of the European Directive. Davies[630] was amongst the first English commentators who recognised the actual result which was brought about by discarding the confidentiality-element, namely, a shift from company law to securities markets regulation. These implications are discussed below in the chapter 'insider defined'.

One further point must be made with regard to the definition of inside information because of the above conceptual change. The remaining elements in the definition are 'non-public' and 'price-sensitive'. After the abandonment of the requirement of 'connection with the company' these elements must now, under the new law, be looked upon as the most important elements .[631] They must therefore be defined in precise terms.

2. 'Non-public' and 'price-sensitiv'

Under the 1985 Act[632], the information had to meet two requirements in order to be regarded as 'unpublished' and 'price sensitive', ie it had to:

(i) relate to specific matters relating or of concern (directly or indirectly) to that company, ie it was not sufficient to be of a general nature relating or of concern to that company[633]

and

(ii) be not generally known to those persons accustomed or likely to deal in those securities but which would, if it were generally known by them, be likely materially to affect the price of those securities.[634]

According to Rider[635] element (i) was obscure. He criticised the fact that it

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(corporate control) at 316; see also Fenn/Mc Guire/Prentice op cit (informational imbalances) at 8.

630 Davies op cit at 99, and at 102. Nevertheless, Davies argues that the fiduciary doctrine can still be applied to the new law even though this must be done in a more sophisticated way, idem at 97; see also Hannigan op cit (1st ed) at 81.

631 Davies, idem at 102.

632 See Hannigan op cit (Insider Dealing) at 52.

633 Sec. 10(a) IDA.

634 Sec. 10(b) IDA.

635 Rider, 'Insider Trading', London, 1983 at 22.

was not clear whether the specificity-requirement would relate to the information or rather to its importance for a company. He suggested that it would be preferable to define 'specific' in relation to the information itself.[636] His opinion was indirectly accepted by the European Directive which added the element 'precise' to the definition of the information. Here the Directive proves to be, at least partly, a result of the English debate. As mentioned above the modelling of the term 'non-public' has been granted much more attention in the new law.

The latter part of (ii) was almost identical to Art 1(1) of the Directive. But the former approach (ie 'persons accustomed to ...') was also criticised for being unclear.[637] Interestingly though, a Singapore Court in Public Prosecutor v Ghoudrie[638] interpreted exactly these elements so as to mean 'precise' and able to 'markedly affect the price'.

III. Analysis of the elements of the 'information'

The question of what is inside information has to be objectively assessed and it is a question of fact in each case whether or not the information possesses these characteristics.[639] Let us therefore now consider the elements of the definition according to the new law.

1. The elements 'precise' and 'specific' under the Criminal Justice Act (Part V) 1993

The information has to be either 'specific' or 'precise' in order to fall within the legislation. This brings about an extension of the old law which only used the term 'specific'. The new term is due to the European Directive, a fact which makes it appropriate to examine this source first.

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636 Rider and Ashe, 'Insider Crime - The new law', Bristol, 1993 at 30; see also Rider/Abrams/Ferran at 137; see also Hannigan op cit at 52.

637 Hannigan op cit at 67.

638 Reported by Rider, '(Singapore) The Court of Appeal 'defines' inside information', 2 Comp Lawy 1981 at 141 et seq.

639 Hannigan, idem at 59.

a) The Directive's use of the term 'precise'

The Directive stipulates that the laws in the Member States should regard as potential inside information only a 'precise' piece of information.[640] According to the explanatory statements of the European Commission, this element requires that the information be more solid than a mere rumour.

This does not exclude the possibility that price changes are sometimes due to information that can be confirmed only later. On the contrary: as we have seen in the Part I, some 'rumours', such as, for instance, price and trading signals, are factors that will often result in a change of the price of securities (derivatively informed trading).[641] In both cases the un-informed trader does not know anything about the contents of the 'real' information, which is released only later. Such derivatively informed trading would not convey any actual information about the state of a company, but rather indicate an altered state through transactions by insiders. Yet it needs to be considered as valuable inside information.

Market authorities will probably not be able to distinguish between informed and un-informed trading. On the other hand, if a person knows that an alleged rumour is wrong, he will be able to profit from this knowledge and buy, for instance, put or call options or, as a professional market participant, go short[642] in the potentially affected share.

b) Difference between 'precise' and 'detailed'

There is, however, another problem with regard to 'precise'. In some cases an insider will impart only fragments of the information. These fragments are then assembled to complete data by the recipient of the information.

In a recent prosecution for insider dealing[643], some relevant data had been

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640 Art 1(1) of the Directive.

641 Therefore, the term derivativlely *informed* trading might be slightly misleading. Nevertheless, these tradings result in a better pricing of the security concerned, see Gilson and Kraakman op cit at 578 et seq.

642 Short sale in the language of the Stock Exchange means selling stock that the seller does not yet possess at the time of the sale.

643 Before Judge Selwood, Inner London Crown Court, 17 Jan 1994, see Nakajima, 'Putting the pieces together - insider liability', 15 Comp Lawy 1994 at 88.

given[644] to Staines and Morrisey by Priddle, a tax specialist working for KPMG. Priddle disclosed certain details of a forthcoming takeover bid, such as price earning ratio, approximate share price of the target company, and the sector in which the firm operated. Priddle did not, however, disclose the identity of the actual parties of the deal[645]. At first sight, the question here seems to be whether or not the information was precise.

Inside information need not be precise in every respect. It is sufficient for the recipient to be able to identify the relevant issuer by piecing together parts of the information. Some authors[646] argue that the defendants dealt on inside information. This is certainly correct.[647] But these authors did not raise the right question, because the information itself (ie the identity of the target company) was absolutely precise at the time when the securities transaction occurred! Thus, doubtlessly, Staines and Morrisey were in possession of a 'precise' piece of inside information. For the definition of what constitutes 'information', it is of no importance[648] how the insider trader was informed. It is important what the trader finally knew, regardless of whether the trader had originally been given a complete piece of information.

The real problem in this case was whether or not Priddle supplied his two friends with full and precise information, ie whether or not he passed on inside information. If he did not mention the names of the parties to the takeover (not even in a metaphoric way), then it must be established that he had reason to believe that the recipients would be able to piece the data

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644 It is reported that this happened during a meal, ie at an informal meeting. This reminds us of Manne`s idea of an 'information clearing house'.

645 Aaronson Brothers and Glunz, a German timber products company.

646 Nakajima op cit, idem.

647 The result is in line with and based on TSC Industries, Inc v Northway, Inc (1976) 426 US 438, at 449. In this decision the US Supreme Court held that inside information includes inferences which a reasonable investor would draw from facts in his possession.

648 It may, however, be important for the definition of the insider!
If, for instance, the prohibition does not cover situations where a person trades as a secondary insider, or, where it is provided that for the recipient to be an insider he must obtain the complete information from a direct insider, then the source of the information would be relevant because otherwise the trade would not be prohibited.

together and to reach the correct conclusion (ie the complete information). This would be proved, for instance, if Priddle knew about the professional skills of his friends.

c) 'or specific'

In order to be regarded as 'inside' the information must also be specific. In this regard s 56(1)(b) of the CJA 1993 contains a deviation from the definition in Art 1(1) of the Directive in that the Directive requires that the information is 'precise', but not 'specific'. In general, the question of how far Member States may alter definitions pre-formulated in a Directive, poses some problems. However, in the case of the Insider Directive, this is not the case, because Art 6 leaves it open to the Member States to adopt provisions more stringent than those laid down by the Directive. Since a disjunctively added term such as 'specific' broadens the scope of potential inside information, more dealings become prohibited. Here the English law is more stringent than the European law.

We still have to find out the exact difference between 'specific' and 'precise'. An example given in the literature is a take-over situation, with the distinction as follows: 'specific' information is that a bid as such was going to be made. 'Precise' information is the price at which that bid was going to be made. On that basis, 'precise' information means narrow, exact and definitive information.[649] Yet the Directive included 'precise' only to distinguish facts from rumour, certainly not in order to exclude take-over bids from the scope of inside information!

The intention of the law is probably to include information which relates to a company (ie that the information 'firm-specific'), even though this information might not yet be 'precise' for an outsider. It is suggested that as soon as the impact of that information on the one firm becomes predictable for an insider, the information is 'specific'. An example for this is where a new kind of medicine has been discovered. Only he who knows how important this breakthrough is for the producing company would possess 'specific' information. Outsiders who might have heard about the new product, but who are not able to assess the value of it for the firm would not possess 'specific' information.

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649 Cf Hannigan op cit at 63.

2. The information 'has been made public'

The information must not have been 'made public' in order to be 'inside' information.[650]

This creates a problem with regard to the European law because the definition contained in Art 1(1) of the Directive only stipulates that the information should be non-public. The English legislator has defined this element in a lengthy way, as a result of which the English definition seems to be quite different from the European . Yet, even though it is much more detailed, the English definition is probably compatible with the Directive, provided it does not narrow down the scope of Art 1(1) too much.

Above all, it is striking that the legislator should have worked so extensively on the new definition. In the original drafts of the Criminal Justice Bill introduced in the House of Lords, no assistance was given as to what was meant by 'made public'.[651] The Treasury Commentary noted that it would not be helpful to provide a detailed definition, because of 'the risk of causing difficulties for legitimate activities or seriously undermining the effectiveness of the legislation'.[652]

Why then was this part of the definition detailed with such extreme precision? In order to answer this question we must first consider what was thought to have been wrong with the preceding definition in the 1985 Companies Securities Act.

a) The definition contained in the 1985 Act (CSA)

The Company Securities Act 1985 (CSA, also referred to as Insider Trading Act, IDA) had provided that the information must 'not be generally known to those persons who were accustomed or would be likely to deal in those securities'.[653] This was criticised as being unclear.[654] In fact, there were various views on this provision. It was argued that the definition required the information to be generally known to market

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650 Sec. 58(1) CJA 1993.

651 Rider and Ashe op cit at 33.

652 See Treasury Commentary op cit para 23.

653 Sec. 10(b) of the CSA (IDA).

654 Hannigan op cit at 67.

professionals.[655] Rider[656] suggested that the dissemination of information to the investing public was not required. It was also argued that the market must have 'internalised' the information,[657] and that the information must have been fully reflected in the price of the securities[658].

It is evident that this element of the former definition must have created a considerable amount of uncertainty. For instance, transactions carried out by insiders before the market had assimilated the information were probably not safe under the 1985 Act.[659] Thus the price had to *adjust* before insiders were able to trade safely.[660] If, however, the question of when professionals are allowed to deal had been considered more carefully, the shorter definition in the old Act might have been clearer than the more detailed but somewhat contradictory version under the new law.

b) Uncertainty tackled under the new Act?

We shall now examine whether the new English law has coped with the problems of uncertainty posed by the old Act. At a further stage of the legal process of modelling the definitions, the Treasury suggested that it would provide extra-statutory guidelines. But critics argued that, on a matter which was such an important element in a criminal offence, guidelines were insufficient. The Government subsequently said that 'when information has and has not been made public is the single issue that had caused most concern to the organisations with which the Government has been discussing the Bill'[661].

Sec. 58 of the CJA 1993 is made up of two alternative meanings of 'public'. The first possibility is that sufficient steps have been taken so that the information has in fact 'been made public'. The second possibility is that the information 'may be treated' as made public. In order for this alternative to become available, one of the various circumstances described in s 58 of the

655 See Anisman, 'Insider Trading Legislation for Australia', Melbourne, 1986, at fn 674, quoted by Rider and Ashe op cit at 39 fn 20.

656 'Insider Trading' op cit at 23.

657 Ashe and Counsell, 'Insider Trading', London, 1990 at 88.

658 Suter op cit at 100.

659 Rider and Ashe op cit at 34.

660 Rider and Ashe, idem at 34.

661 HC Debs, Session 1992-93, Standing Committee B, 10 Jun, col 182.

CJA 1993 must be present.[662] We shall see that especially these 'circumstances' have been modelled under the strong influence of certain interest groups in the financial industry.

aa) Information 'published according to market - rules'

Sec. 58(2)(a) of the CJA 1993 provides that information is made public if it is published in accordance with the rules of a regulated market. This covers situations where information has been released by the Stock Exchange´s Regulatory News Service (RNS) as required by the listing Rules.[663] This, it would seem, has the effect that information which issuers wish to notify[664] must be delivered in the form of an announcement to the Company Announcement Office (CAO). The Stock Exchange then arranges for the prompt publication of announcements through the RNS, which operates between 7.30am and 6.00pm. Announcements notified up until 5.30pm are released on the day of receipt. It would be at this point, for example, if there was an announcement on TOPIC (ie one of the Stock Exchange announcement systems), that it would be 'made public' for the purposes of s 58(2)(a) of the CJA 1993.[665]

Rider and Ashe[666] criticise this part of the definition, because (although it has the advantage of clarity) it has the disadvantage of creating uncertainty with regard to the time when insiders may deal. Quoting Hopt[667], they suggest that the Directive must be interpreted in such a way that insiders have to wait for the market to assimilate the information. To allow insiders to deal on publication of the information would give them an advantage over the rest of the market, for they could, so to speak, be ready at the

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662 Hannigan op cit at 67.

663 Hannigan at 68.

664 Notification according to the Listing Rules, Chapter 9. The release of price sensitive information is important. The Stock Exchange working party issued a document called 'Guidance on the dissemination of price sensitive information'. In this document it is recommended that such information is exclusively released through the CAO. See Smith, 'Release of price sensitive information: Stock Exchange guidance', 15 Comp Lawy 1994 at 89.

665 Rider and Ashe op cit at 34.

666 Idem, at 34.

667 Op cit at 51.

starting blocks the instant the information became public, and before it has had its full impact on price.[668] The preamble to the Directive, however, sought to protect investors who need to be 'placed on an equal footing'.[669] With respect, a complete quotation of the Directive would correct this view. The preamble to the Directive runs:

> 'for the market to ... play its role effectively, every measure should be taken to ensure that the market operates smoothly; whereas, the smooth operation ... 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' ....[670]

Confidence may at times be different from 'equal footing'. As we have seen above, the content of a Directive has to be interpreted in the light of its preamble. Without entering into a discussion of all the interpretational details of this preamble, it is obvious that the intention of the Directive was to ensure the functioning of the market, and not in the first place to guarantee the maximum of investor protection.[671] Therefore, as far as the European law is concerned, the definition of 'made public' implies that the information should be absorbed by the market. One might be able to criticise this result de lege ferenda, but is a matter fact de lege lata.

Another problem is raised by s 58(2)(a) of the CJA 1993. The RNS is a service to which one has to subscribe. Thus, even though information is announced to the CAO as required by the Stock Exchange´s Listing Rules, it is, at least initially, obtainable only by those who subscribe to the service.[672] However, the great majority of banks, brokers, agents, and intermediaries have subscribed, so that this problem does not exist in practice. It is therefore suggested that information is 'public' once it is announced on the Stock Exchange.

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668 Rider and Ashe op cit at 34.

669 Rider and Ashe, idem at 39 fn 21.

670 Preamble to the Directive, para 3-5. The emphasis is made by the author.

671 Tippach op cit at 20 et seq.

672 Hannigan op cit at 68.

bb) Registered information

Data contained in records which by virtue of any enactment are open to inspection by the public is 'made public' according to s 58(2)(b) of the CJA 1993. Of course, information registered at the Companies House or at the Patents Registry also falls within the scope of the provision.[673]

The essential requirement here is that the records must be open to inspection by the public, which excludes publication in obscure registers. It was suggested[674] that this alternative might encompass the Official Gazette, but it seems not to be included within the provision, for, while it is an official record, it is not a record which by virtue of any enactment is open for inspection by the public (although many public libraries may subscribe to it).[675] This is a weak point in the legislation, because one of the first things that would seem to need clarification is whether publication in such an important document as the Official Gazette is included in the definition of 'made public'.

cc) Information readily acquired by people 'likely to deal'

Information is further 'made public' in terms of s 58(2)(c) CJA 1993 when it can be readily acquired by those likely to deal in any securities to which or to whose issuer the information relates. This formulation contains an element of the old 1985 Act ie 'those likely to deal',[676] which seemed to be difficult to apply in practice. Yet, there is a very important difference. Under the CJA 1993 it is sufficient that the information may be readily acquired, even if it is not 'known' (!) by those likely to deal.[677]

Hannigan[678] argues that it is not clear whether information is 'readily acquired' if it can be obtained on networks more expensive and less widely available than TOPIC. This is unconvincng. Either information can be published under s 58(2)(a) (ie 'in accordance with publishing rules') or it

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673 Hannigan, idem at 68.

674 Parliamentary Debates, HC, Standing Committee B, 10 Jun 1993, col 184 (per the Economic Secretary).

675 Hannigan op cit at 68.

676 See Hannigan op cit at 68; see Rider and Ashe, idem at 35.

677 Hannigan, idem at 68.

678 Idem, at 68.

cannot. To extend the networks which an issuer can use to publish relevant data via s 58(2)(c) of the CJA 1993 would lose sight of the importance of the publishing requirements. If a network is not even suitable for the purpose of publishing the information according to the Listing Rules, it can certainly not make the information 'public' according to the insider trading provision, because 'public' would still mean more or less the same under those provisions.[679] It is therefore submitted that 'those likely to deal' cannot be reached through a network which would not fall under s 58(2)(a) of the CJA 1993.

Rider and Ashe[680] argue that, if information can be 'readily acquired' by the market, this information is already likely to have made its price impact and can therefore not to be regarded as inside information. These authors tend to over-estimate the element of 'price-sensitivity'. If the English legislation had had the intention to make sure that the information has its full impact on prices *before* insiders are allowed to trade, it would have chosen a definition like in the South African law (ie which allows for extra time to digest the news). But this was not the case. Thus information need not be 'readily acquired' by the whole market for it to be 'public'.

On the other hand, the formulation 'those likely to deal', although criticised for being awkward, is an important element for the correct interpretation of the Directive.[681] However, it would seem that 'persons likely to deal'ought to have been defined more precisely.

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679 It seems appropriate to refer here to the principle of 'linguistic economy', ie the recognition of the 'own-meaning' of each of the structural components of meaning of the enactment must be pursued, except in instances where words, phrases or sentences are employed ex abundanti cautela, see Du Plessis, 'The interpretation of statutes', Durban, 1986; see, however, Cockram, 'The interpretation of statutes', 3rd edition, Cape Town, Wetton, 1987 at 40, for the exeption from the above interpretational rule in cases where two statutes which contain the same words must be read differently, for instance, in a technical statute. The reference to context makes it necessary to look at the purpose of the statutory provision and should, if one is found, produce a 'purposive construction', see Ashworth, 'Interpreting criminal statutes: A crisis of legality?', (1991) 107 Law Quarter Review 419 at 428.

680 Op cit at 35.

681 Tippach op cit at 120.

dd) Information derived from published data - the problem of research recommendations by analysts

Sec. 58(2)(d) of the CJA 1993 provides that information is also public if it is derived from information which has already been made public. It becomes obvious from the debates and the Treasury Commentary that this provision intends to make clear that information derived by analysts from previous information, which had already been made public, is not itself inside information.[682]

This provision is a direct result of the transposition of the European Insider Directive. The preamble to the Directive stipulates that '... estimates developed from publicly available data cannot be regarded as inside information and ... any transaction carried out on the basis of such estimates does not constitute insider dealing ...'[683].

This does not, however, exclude that the fact that a recommendation made to the customers of a bank can be regarded as inside information. Suppose, for instance, a colleague learns of the analyst´s recommendation ahead of its publication and deals on his own behalf. Did he possess inside information? It could be argued that he is within the legislation, ie that he dealt while in possession of inside information. In this instance, knowledge of the recommendation itself would not constitute inside information; but the fact that such a recommendation was about to be made would constitute insider knowledge.[684] This is assuming that all the other elements (most importantly the significant effect on the share price) are present.[685] Since recommendations by influential analysts often lead to price shifts, it is correct to subsume such information under the legal definition.

Yet, the problem of recommendations does not seem to be whether or not the information 'has been made public', but rather, whether the information can at all be regarded as information within the legislation. One could argue that the information does not stem from inside a company but is related to the shares of that company, which means that it is market information.[686]

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682 See Treasury Commentary op cit para 27; Hannigan, op cit at 68.

683 Preamble to the Directive, para 13.

684 Hannigan op cit at 69.

685 Hannigan, idem at 69.

686 See below, 3: group (v).

Genuine research recommendations by analysts based on public information (unlike situation where the analyst bases his recommendation on a meeting with the company chairman) are treated as information which 'has been made public' and not as inside.[687] Hannigan[688] thinks that it may eventually be difficult to distinguish between these two scenarios.

A US court has summarised this problem by saying that 'a skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material *non-public* [689] information. Whenever manager and analyst meet elsewhere than in public, there is a risk that the analysts will emerge with inside material information.[690]

Rider and Ashe[691] think that the danger recounted by that court should not arise in the UK, provided that the mosaic which contains the inside information is derived from information which has been made public.

This is indeed a critical issue because in practice these scenarios would not occur separately, but, in most cases, both sorts of information will be mixed. The analyst may have derived his evaluation from public data, and later he finds his opinion confirmed by the chairman during a firm visit (the latter would certainly be inside information). Would his subsequent recommendation then be based on 'public' or on 'inside'information? All this leaves us with much uncertainty, and it also reveals that strong influence of interest groups does not result in clearcut definitions.

c) Information which 'may be treated' as made public

Further provisions of the CJA 1993 provide for situations where information 'treated' as having been made public, even though at first sight the circumstances may indicate otherwise. The fact that the information arises in situations does not necessarily mean that it will not be treated as

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687 Hannigan op cit at 68.

688 Idem, at 68 fn 39.

689 My emphasis.

690 Elkind v Liggett & Myers, Inc 635 F 2d 156 (2d Cir 1980) at 165; see also Rider and Ashe, op cit at 35.

691 Rider and Ashe, idem at 36.

'made public'. The issue is then a matter for the courts to decide.[692]

English commentators think that these provisions are not entirely satisfactory but the Government claimed in debate[693] that it was important to insert these examples of information which may be treated as having been made public, because many people felt that unless such examples were included, information might be considered 'not made public'.[694] Originally, as a result of pressure by the securities industry, the Government wished to issue non-statutory guidance notes. This was abandoned, though, and replaced by a statutory basis for what could turn out to be what Rider and Ash call a 'plea in mitigation'.[695] They think that defendants would always try to refer to these examples, claiming that none of them was actually 'fulfilled'.[696] The Minister said, however, that only[697] 'if a recipient of the information had considered that it had been made public, should the information be treated as if it had been made public'.[698]

All this is not very convincing. Even if one wants to apply these provisions with all the exceptional circumstances in which information 'may' be regarded as being made public, the burden of proof is still on the prosecution. Thus the courts will have to establish that the insider intentionally made use of inside data. Consequently, there must be evidence that none of the exceptions contained in s 58(3) is applicable, and thus it will never be the insider who needs to prove their applicability.

A particularly negative side-effect of these exceptional circumstances is that they render the underlying concept of the law unclear. The only persons who profit from such 'exceptions' are secondary insiders from the financial service sector. It would seem that these exceptions were created under the

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692 Rider and Ashe, idem at 36.

693 Parliamentary Debates, HC, Standing committee B, 10 Jun 1993, col 184 (per the Economic Secretary).

694 Rider and Ashe, idem at 36.

695 Idem at 36.

696 Idem, at 36.

697 My addition.

698 Standing Committee B, 10 Jun 1993 col 184 (remarks of the Opposition spokesman, Mr Alistair Darling MP); see Rider and Ashe op cit (Insider Crime) at 36; Wotherspoon op cit (1994 Moder Law Review) at 424 adopts this view, too.

influence of these 'City' people. Since most big insider cases[699] occur in connection with investment bankers and other financial intermediaries, these provisions will help rather than deter such insiders.

aa) Information that can be 'acquired only by persons exercising diligence or expertise'

Sec. 58(3) of the CJA 1993 goes on to provide that information may be 'treated as made public' if it can be acquired only by diligence or expertise.[700] A typical situation where information can be acquired only through diligence might be where an analyst consults large numbers of technical scientific journals or an obscure foreign journal, and discovers information which will affect a new product.[701] Information in an obsure foreign journal needs to be distinguished from s 58(3)(e) (ie 'published outside the UK'), for information in an obscure journal is not 'published' in the true sense of the word. Only then would it be possible to subsume the publication under s 58(3)(e). If the journal is 'obscure', the only alternative under which this can be subsumed is provided by s 58(3)(a).

Wotherspoon[702] suggests an assiduous investment analyst who reads through relevant but obscure technical journals seeking information may safely issue recommendations to his fund manager. But is this convincing? The formulation 'may be treated' gives the courts a large degree of discretion. It therefore depends on the courts how this concept of 'exceptional circumstances' is going to be applied. Until there is some case law available on this question we have no certainty with regard to such recommendations. Instead, the analyst must be careful when his professional advice is based on information of that kind. Yet, in the long run, especially if the exceptions are generously applied, the view will no doubt prove right.

bb) Information is communicated to a 'section of the public'

A piece of information that is communicated only to a section of the public and not to the public at large, may also be regarded as made public[703]. This

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699 Like the Boesky case or the Levine case.

700 Sec. 58(3)(a)

701 Parliamentary Debate at col 183; Rider and Ashe op cit at 36; Hannigan op cit at 71.

702 Op cit at 423 et seq.

703 Sec. 58(3)(b).

alternative covers situations where information is released on an expensive market information service, depending on the scope of the service.[704]

The formulation suggests that it is not enough to communicate the information to a group with a common characteristic, eg the group of 'analysts'. The group has to be representative of 'the public'.[705] The absence of an adjective qualifying 'section' allows the court a considerable degree of latitude in cases where there has been only partial public disclosure of significant information.[706]

Hannigan[707] asks whether information is communicated to a section of the public if it is the subject of a press release issued to newspapers, radio or television stations prior to the Stock Exchange announcement. Since radio etc get the information prior to the Stock Exchange announcement system, it is unlikely that information could be regarded as made public when communicated to a radio station.[708] The example furnished by Hannigan would thus never be within the scope of the provision - even if the information were not embargoed. Television, radio and newspapers address the public at large, and not only a section of the public. It is hence unlikely that a court would apply this provision when information is so released.

cc) Information can be acquired only by observation

Information may also be treated as 'made public' when it can be 'acquired only by observation'[709]. Wotherspoon[710] furnishes the example of a manufacturing company's storage yards that have in recent months stockpiled finished goods, a fact that may be regarded as a disclosure concerning the state of the company's order book. This is probably wrong, because the state of the order book can be acquired verbally as well.

Another example was originally given by the Minister[711]: 'the point to

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704 Hannigan op cit at 71, with further reference at fn 45.

705 Lomnicka op cit at 178 fn 55.

706 Wotherspoon op cit at 424.

707 Op cit at 71.

708 Hannigan, idem at 71.

709 Sec. 58(3)(c).

710 Op cit at 423.

711 HC Debs, Session 1992-93, Standing Committee B, 10 Jun 1993, col 184 (per the

consider is whether a factory chimney smoking at night could be regarded as public information, since everybody could go and see a smoking chimney and take the view that the factory was working overtime, or whether it would be regarded as information that had not been promulgated or made public. The point is that the court can decide the matter taking into account all of the circumstances.'

This example is hardly better than the first one, because the fact that a chimney is smoking at night certainly lacks the element of precision which is necessary for the information to fall within the legislation. Nor is it specific[712], because a smoking chimney cannot possibly alter the opinion on a whole company (we are talking about LSE-quoted companies!). Moreover, the state of the factory (company) may as well be communicated verbally. This alternative is obscure.[713]

dd) Information is 'communicated only on payment of a fee'

If the information 'is communicated only on payment of a fee', it may also be regarded as 'made public'.[714] This seems to cover situations where an investor is in possession of information as a result of subscribing to an information service or having read an industry research report. In the Parliamentary debate it was said that the point here is that 'payment clearly cannot have the effect of preventing information from becoming public, but payment itself cannot be sufficient to make information public'.[715]

In other words, payment is just a factor which the court considers in deciding whether or not the information has been made public.[716] It is submitted that this provision again reveals the extent to which the exceptions are moulded in favour of the financial service people. It should be clear that any payment for information with the intention of making use of it as inside data in order to make profit in securities transactions, cannot fall within the scope of this provision.

Economic Secretary); cf Hannigan op cit at 71; cf Rider and Ashe op cit at 36.

712 See Hannigan op cit at 71, but without furnishing any reason for her view.

713 According to Lomnicka op cit at 178 fn 56, it 'would seem to add little to the first alternative'. This result is indeed very likely.

714 Sec. 58(3)(d).

715 HC Debs, Session 1992-3, Standing Committee B, 10 Jun 1993, col 182.

716 Hannigan op cit at 72.

ee) Information has been 'published outside the UK'

The final alternative containing a description of exceptional circumstances in which information may be treated as having been made public is that of information published outside the United Kingdom.[717] Fears were expressed in Parliament that the last part of the provision could enable potential insiders to cause the publication of the information in an obscure foreign newspaper, and thus provide them with a defence.[718] This was also an issue under the former South African legislation.[719]

English commentators quote as examples the New York Times[720], The Wall Street Journal[721], Die Zeit[722] or Handelsblatt[723] - as opposed to information carried solely in local or regional (the Tonga Evening News[724]) newspapers.[725] It is appropriate to distinguish between the alternatives (a) (ie information 'acquired by expertise') and the one dealt with here. 'Expertise' may encompass an obscure journal which does not normally contain relevant market information. However, and not only textually, there has to be a difference between the first alternative and this one.

It is important to note that the wording encompasses information only when it is 'published' outside the United Kingdom. Expertise and diligence, however, can neither mean 'published' according to the English (listing) rules, nor can it be understood to include information which is contained in obscure technical journals. On the contrary, obscure journals would seem to fall within the scope of s 58(3)(a) of the CJA 1993. Therefore, 'published' must be interpreted in this context to mean publishing instruments communicating (ie in that other country) to the public at large. Thus,

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717 Sec. 58(3)(e).

718 See Lomnicka op cit at 178 fn 58.

719 Cf Rider op cit at 445.

720 Hannigan op cit at 72.

721 Wotherspoon op cit at 423; Hannigan, idem at 72.

722 Wotherspoon, idem at 423, writes: Die 'Ziet' which is probably due to a printing error. The German weekly paper is called 'Die Zeit'. It should be noted that 'Die Zeit' will rarely publish new data relevant for the Frankfurt Stock Exchange simply because it is a weekly paper.

723 Rider and Ashe op cit at 36.

724 Rider and Ashe, idem at 36.

725 HC Debs, Standing Committee B, 10 Jun 1993, col 183.

information may 'be treated as made public', if it has (ie without the discretion given by the English legislator) to be regarded as 'made public' according to the legislation in that other country. It would not seem to make a difference which kind of publication this is. Thus, radio, television, informational systems, Stock Exchange Tickers and newspapers are included as long as they 'make the information public' in the other country.

It was argued that the prosecution should fail where the defence is able to show that the publication was regularly read by experts because of the consistent quality of its coverage of their field of interest.[726] Again, it would seem that the defence cannot be required to provide evidence that the information 'may be treated' as made public but, on the contrary, the onus is on the prosecution to establish that it was still (ie at the time of the dealing) 'inside' information.

In the House of Lords the point was made that given the modern speed and ease of communication, it is difficult to conceive situations in which information is available abroad, but cannot be obtained in the UK.[727] This approach is convincing. The only thing which could happen is that the different trading hours (caused by the time difference eg between Tokyo and London) would result in a later publication in London. Normally, however, prices of shares which are traded worldwide adjust very fast to the new data available on a foreign Stock Exchange, so that London stock prices can be expected to react more on the changed price in Tokyo than to the information itself.

d) CJA 1993: extra time to digest the news? A conclusion

As we saw in our examination of the South African definition of inside information,[728] it is conceivable that news items, although publicly available, may still, in terms of the insider trading laws, be regarded as 'inside', thus leading to a criminal offence when this information is used for capital market transactions. The law would then provide for some extra time after the publication before insiders are allowed to trade.

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726 Col 184 (remarks of the Opposition spokesman Mr Alistair Darling MP).

727 HL Debs, Session 1992-93, 3 Dec 1992, col 1503; Hannigan op cit at 72.

728 The South African legislator has provided a digesting time of 24h which must have elapsed after the release of the information in order to prevent the trader from insider

The English insider dealing provisions make one thing clear: insiders are allowed to deal on publication. Whether or not this is satisfactory for outsiders - the very moment the information is published, insiders can start putting orders in the market. Rider and Ashe[729] regret this, because it gives insiders an advantage over the rest of the market. This seems to be even more the case when information is only 'treated' as made public because insiders seem to be able to trade at an even earlier stage of the price adjustment process.

These authors refer to the Texas Gulf Sulphur (TGS) case[730] where it was held that insiders must wait for the market to absorb the news. Yet, the facts of that case were different from the situation envisaged by the new English law. In TGS the relevant information was 'published' only at a press conference, after which orders were given before the information had reached the market. Since journalists on a press conference do not even constitute a sector of the public[730a], the information would neither be regarded as 'made public' nor 'may' it 'be treated as made public'. Consequently, the fears of Rider and Ashe are not well-founded.

3. Market information and government data

It is an interesting question whether insider trading provisions are wide enough to encompass information such as Government figures or financial data. Would knowledge of the Government's foreign borrowing plans, for example, or UK trade figures, or the information that interest rates are to go up or down, be seen as inside information?

In England, indeed, there have in the past been allegations of large dealing in gilts and other securities as a result of a leak about ERM entry in October 1990, and again in September 1992 ahead of the Government's L7.27bn foreign currency loan.[731]

It is appropriate to clarify the notion of 'market information' before entering into a detailed discussion, for it seems that there is considerable confusion about what the term is meant to include. To this end it is helpful to divide market-related news into certain groups which can, in a second

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liability.

729 Op cit at 34.

730 SEC v Texas Gulf Sulphur Co 401 F 2d 833 (2d Cir 1968).

730a The task of journalists in any medium is to inform the public - thus they cannot be considered a section of the 'public at large' which is the actual meaning of 'public'.

731 See Hannigan at 62 who gives some additional references, idem at 62 fn 10.

step, be connected with the text of the law.[732] Neither groups nor examples should be regarded as conclusive, but allow further information to be more easily classified. The five groups are:

(i) Political news: governmental decisions, embargo resolutions, death or illness of a politician, law-projects; wars, natural disasters.

(ii) Exchange rates, currencies, natural resources: changes in exchange rates by the Federal Reserve Banks, order volume in currency-dealings, activities of the Federal Reserve on the markets, prices of resources such as oil, metals or other.

(iii) Statistics concerning the whole economy: price rates, unemployment numbers, GNP, number of business breakdowns in a given period.

(iv) Statistical material concerning sectors of the industry: see information sub iii with regard to one specific industrial sector, for instance number of new cars in the previous month, used capacities in factories; the development of a new technique to produce artificial diamonds (which would affect firms in that branch in South Africa).

(v) Securities dealings: order volume, individuals buying or selling stakes, buys by big investment houses or funds, investment advice or recommendations (either buy or sell or hold) to be published, price stabilisation dealings.

a) Does the English law encompass market information?

Firstly, s 52 of the CJA 1993 (ie the insider prohibition) does not apply to anything done by an individual acting on behalf of a public sector body in pursuit of monetary policies or policies with respect to exchange rates or the management of public debt or foreign exchange reserves.[733] This is striking because, if data such as exchange rates were not looked upon as insider-relevant information, the exemption provided in s 63(1) of the CJA 1993 ie that 'an individual acting on behalf of a public sector body in pursuit of monetary policies is not guilty of insider dealing', would be of no practical value.

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732 See Tippach op cit (Marktdaten) at 1270.

733 Sec. 63(1) of theCJA 1993.

In order to reduce the risk of insider dealing on Government data, the Central Statistical Office announced in February 1993 that it was further restricting the circulation of economic data prior to publication.[734] Thus, the Government appears to have recognized the relevance of such information for insiders. This perspective is in line with the recognition that under the new law the scope of persons regarded as insiders is far wider than it used to be under the 1985 Act (CSA), so that a person working in the public sector now falls within the legislation, even without being specified as public servant by statutory instrument.[735] The abandonment of the confidentiality requirement is also of importance here. Data which is external to a company could hardly be included under a regime that places restrictions only on dealings where the information needs to be part of a fiduciary relationship with a company.

Secondly, according to s 60(4) of the CJA 1993, information shall be *treated* as relating to an issuer also where it may affect the company's business prospects.[736] The emphasised part of the formulation reveals that the new law seeks to make the definition of information sufficiently broad to encompass a broader system of data than just news originating from inside the companies.

News about major customers, suppliers, creditors, debtors can all have an affect on the company's business prospects.[737] Similarly, if a regulatory body decides to licence operator B in an area where company A has previously had a monopoly, then this will affect the prospects of both companies A and B, and also those companies likely to take advantage of the relaxation. Such information would therefore fall within the scope of s 60(4) of the CJA 1993,[738] although it is not 'internal' company data.

We should note, however, that this type of information is within the scope of s 60(4) only where insider transactions are carried out in the shares of company A. Where an insider deals in shares of the competitor companies, the information would be within s 56(1)(a) of the CJA 1993 since it relates directly to an issuer of securities.

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734 Hannigan op cit at 62 giving additional reference, idem at 62 fn 12.

735 Hannigan at 82.

736 My emphasis.

737 Hannigan op cit at 60.

738 Hannigan, idem at 60.

Thirdly, it is interesting to consider another defence, namely, that 'an individual is not guilty of insider dealing if he shows that (i) the information was market information and (ii) that it was reasonable for an individual in his position to have acted as he did'.[739] Market information for the purpose of this defence is information listed in para 4 of Sched 1. It encompasses information about 'facts', namely that (a) securities of a particular kind have been or are to be acquired or disposed of, (b) that securities have not been acquired, (c) the number of securities acquired or whose acquisition is considered, (d) the price at which they are to be acquired, or (e) the identity of the persons involved.

Dealing on the strength of this type of data does not in itself constitute a defence unless it can also be established that the insider acted reasonably for an individual in his position. This clearly indicates that such market information is within the scope of the insider dealing prohibition.

Thus the way is generally open to include market information. But it is not clear whether or not all market data are included. This issue has, once again, to be seen against the background of the Directive. If the definition provided by the Directive encompassed market information, the English law would be underinclusive when narrowing down the scope of information too much.

b) The Directive and 'Market Information'

Whilst the provisions of a Directive do not have a horizontal effect, it is clear that courts are bound to interpret the English law to give effect to Community obligations.[740] It is appropriate to apply the different methods of interpretation discussed above which the European Court would choose in order to establish whether market information falls within the scope of the definition or not. At the time of the preparations for the new insider legislation in Germany, this question was raised because the inclusion of any kind of external information meant a radical change to the pre-existing self-

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739 Sched 1 para 4. This provision will be dealt with at greater length below, chap 4 sub 'offences and defences'.

740 Marleasing SA v La Commercial International de Alimentation SA, 1992 CMLR 305; see on this issue also Gore-Brown, §12.22 at 12.031.

regulatory system.[741]

The European Court of Justice would presumably start with an objective analysis examining the wording of Art 1(1) of the Directive. In this definition there is no textual restriction to internal company information. On the contrary, according to Art 1(1) information is included which either relates 'to one or several issuers of transferable securities or to one or several transferable securities'.

The Directive relates to '... issuers or ... securities'. This has been expressed disjunctively but the intention of the distinction is not readily apparent, because one would presuppose as an economic fact that the value of the firm is, more or less, mirrored in the price of its shares. Thus it is not obvious why the Directive distinguishes between information relating to an issuer and information relating to securities. It would seem that all public (and sufficiently important) information about a company does affect the company's securities and, vice versa, that no relevant information relating to a security would result in a lasting shift in security prices if the company itself was not at all affected by that information.

A good example for this interaction between security and company is the volume of trades following the information that an insider has executed a transaction. Here we have to remember how information is incorporated in the price of a security: the trades subsequent to the insider´s trades are not 'informed trades' (ie the traders do not have the actual information, yet they know that an insider has traded), but are so-called derivatively informed tradings. The other market participants react upon such a 'trade signal' sent out by the insider trader who is supposedly in possession of non-public information. Market participants, who observe trades and 'recognize' an insider, do possess information only about the identity of a trader, which in itself is market information (ie information in the sense of para 4 of Sched 1(e): 'identity of persons involved'). But only if the true insider really possessed relevant information prior to his transaction, would the shift in security price be a lasting one. Otherwise the price re-adjusts at the former level.

Derivatively informed trading by market participants who react on price or volume signals constitutes another fine example for the interaction between

741 Tippach op cit (Marktdaten) at 1269 et seq.

the 'effect on securities' and the 'value of the firm'. Despite the fact that security price and firm value normally correspond, one can observe that, depending on whether a piece of information is internal or external to a company, its influence is different. Information from inside the company, once it has been made public, influences the appreciation of the investors towards the company, and the change in the security price is subsequent.

In the case of external information investors´ assessment of the company (or the companies) changes because of the conclusions drawn from derivative facts such as insider trades, price signals, or a shift in base metal prices which affect the prospects of a specific industrial sector eg the chemical or the mining industry.

We can observe the same phenomenon where political information such as the Government´s decision to join an international organisation or a monetary system (EU, ERM, ECU or other) is concerned. A shift in security prices subsequent to this kind of information does not occur because of its direct relation to 'one or several issuers', but because investors think that conditions for securities trades in general or for a specific sector have changed. Such information relates to securities and only indirectly to issuers. It is therefore market information.

It has become clear that the disjunctive expression (ie 'relates to issuers *or* securities') used by the Directive intends to encompass both company and market information. It is necessary for market information to be related only to one or several securities because otherwise the information cannot be subsumed under these alternatives, and could not, therefore, be regarded as inside information. Information related to the market in general, however, does not fall within the definition of the Directive.

Hence information which can be classified in the above groups (i) (ie political news) or (iii) (ie statistics concerning the whole economy) are not within the scope of the definition of the European law.[742] Other methods of European interpretation, in particular the teleological interpretation, lead to a confirmation of this result.[743]

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742 Tippach op cit at 1273 et seq.

743 Tippach at 1270 et seq.

c) The English definition in the light of the Directive

In the light of the telos set by the European Insider Directive, the interpretational analysis of the English definition suggested by Hannigan is probably correct. She thinks that borrowing requirements and interest rates can have a significant effect on the gilts markets[744] (remember that gilts are now, under the CJA 1993, included within the statutory definition of 'securities'). Information concerning those requirements or the interest rates can therefore be regarded as information that relates to particular securities - and is therefore market information.

The wide scope of the provision is tempered by the fact that it provides only one element of the definition, and so, while most information is within the scope of this provision, much of it falls at hurdles. In particular, it will often happen that information does not have a significant effect on the price of 'any' securities.[745]

Hannigan also suggests that not all economic data is caught, and furnishes the example of information about UK trade figures of inflation which would not be included, because it is information that does not relate to particular securities or particular issuers of securities generally.[746] This is in line with s 56(1)(a) of the CJA 1993 which stipulates that information 'relates to ... and not to securities or issuers of securities generally'.

Gore-Brown[747] thinks that the bank rate is not caught. This would certainly be a flaw in the provision because this kind of information is vital for capital markets (and, of course, for insiders). Here we have to wait for case law. Nevertheless, the general impression is that, as far as market information is concerned the English legislator has perfectly understood the intentions of the European law, and has adequately transposed the Directive.

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744 Hannigan op cit at 62.

745 Hannigan, idem at 62.

746 Hannigan, idem at 62.

747 Op cit at 12.031.

4. Price-sensitivity

The final aspect of the definition of 'inside information' is the price sensitivity of the information. The fact that the information, if made public, would be likely to have a significant effect on prices is probably the essential feature of the definition. It is this criterion which matters, rather than the issue of how 'qualitative' the information really is. At the end of the day price-sensitivity will be the most determining factor when a jury considers whether or not information is relevant. Therefore, Rider and Ashe[748] regard the price-impact as more important even than the information itself. This, however, is doubtful. The purpose of the legislation seems to be clear. As a result, only information that is likely to have a significant impact is within the reach of the law.[749]

Yet no guidance has in fact been given as to what precisely amounts to a significant effect.[750] Gore-Brown concludes that 'we are talking about unexpected and sensational events'. It seems doubtful, if not exaggerated, to require that the information must be 'sensational'; and 'unexpected' is in fact little more than a synonym for 'not made public'. Besides, to whom should the information appear sensational? In every case there are probably numerous different views, depending on whether it is the appreciation of private clients or that of professional analysts. Even if the information is not 'sensational', it may render the trader able to outperform the market. It would seem to be the legislator´s task to mark the line between insider dealing and dealing on information which 'may or may not' be relevant to markets and investors. The definition should certainly encompass less information than 'any data', but more than just 'sensational' news.

No guidance has been given, because, as the Treasury commentary noted, the range of securities which is covered by the legislation is such that it would not be practical to indicate what precisely is significant.[751] Thus the significance of the price change does not purport to have a universal indicator such as a fixed percentage of the expected price shift. For example, the price change which is significant in the context of gilts would

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748 Rider and Ashe op cit (Insider Crime) at 37.

749 Gore-Brown op cit at §12.22 at 12.035.

750 Hannigan op cit at 74.

751 Treasury Commentary op cit para 25.

certainly be very different from that of options or shares[752] - even as price a reaction on the same information.

A starting point for an interpretation of what price sensitive means is to call for caution: it is possible to misjudge the formulation 'if made public ... would be likely ...' as meaning either 'whether it *will* have an effect'; or whether *that effect will be* significant.[753] Both interpretations are wrong,[754] because the actual effect which the information has on the security price is not in itself decisive. Both could only really be tested at the moment when the information is released, not, however, when the insider trading occurs, ie where, by definition, the information is not known to the public and can therefore not have an actual price impact yet.[755] Yet to carry out a transaction, where the price reaction occurs *after* the transaction, but *before* the announcement of the information to the public is made, is certainly insider trading

Nevertheless, most English commentators think that there will be an element of hindsight here because the courts will know the price movement which did in fact occur after the information had been made public. Thus it would seem that, where the insider has dealt close to the time of publication, evidence of the price sensitivity can be shown by the effect the information had on the market.[756] This thought was expressed by Knox J. in Chase Manhatten Equities Ltd v Goodman[757]:

> 'I am satisfied that it (ie the inside information) would, if generally known, have been likely materially to affect the price of the company's shares. The proof of the pudding is in the eating in that when the suspension (ie a pending announcement of the inside information) was lifted, the price of the company's shares was sharply down.'

The actual impact of the information when it is disclosed can be used as an indicator of 'price sensitivity' only where the insider transaction occurs at a

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752 Hannigan op cit at 74.

753 Hannigan, idem at 74.

754 Hannigan, idem at 74.

755 Cf Rider and Ashe op cit at 37.

756 Rider and Ashe at 37; Gore-Brown op cit at §12.22.3, and at 12.035.

757 [1991] BCLC 897 at 931.

point in time proximate to the disclosure of the information.[758] Otherwise it would be too difficult to prove that the trade was based on the information. But taking into account the skills and the routine of most (real) insiders, it will hardly ever occur that they deal close to announcement. The above interpretations are therefore too restrictive.

The evaluation will depend on the facts. It is impossible to analyse the English concept by reference to quantification.[759] Rider and Ashe[760] in particular make reference to the US case of Elkind v Liggett & Myers, Inc[761], in which it was held that the fact that a company´s shares dropped 11 3/4 points on disclosure of information did not establish price sensitivity in view of the fact that a substantial decline in the company´s shares was not uncommon. This is an important point: the courts probably have to take into consideration the usual volatility of the shares in order to establish what kind of price shift is substantial for a specific security.

It is also important to note that a significant change in price is not the only means of establishing that inside information is price-sensitive. The net is cast wider because, for the purposes of defining inside information, 'price includes value'.[762] 'Value' is a wider concept than price, and it is hard to see that 'price' encompasses 'value' other than in an indicative character.[763] This complicates the matter further, because the price of a particular security may or may not reflect its value. The value of a security is an estimation for which the price is in most cases the best guide.[764] Neither in the Directive nor in the English law is the actual price change a qualifying factor that determines the inside character of the information. Thus the word 'value' seems to direct the attention more to the importance of the *contents* of the news.

For these reasons Rider and Ashe suggest that the courts must propound a 'reasonable investor' test relative to the securities in question and leave the matter to the jury. This US-American approach, agreeing with TSC

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758 Gore-Brown at 12.035.

759 Rider and Ashe op cit at 37.

760 Idem, at 37.

761 635 F 2d 156 (2d Cir 1980).

762 CJA 1993, s 56(3).

763 Gore-Brown op cit at §12.22.3, and at 12.035.

764 Gore-Brown, idem at 12.035.

Industries Inc v Northway Inc[765], has been adopted by the Australian legislature. Section 1002C of the Corporation Act reads as follows: '... a reasonable person would be taken to expect information to have a material effect on the price ... if the information would be likely to influence persons who commonly invest in securities ...'[766].

These authors concede, however, that the above approach does not really help. Except in the most blatantly obvious[767] cases, there must be a careful analysis of the evidence supporting what is 'a significant effect' on the price.[768] In some cases the matter will have to be dealt with by expert evidence.[769] Gore-Brown[770] says rightly that it is to be hoped that the courts will not become bogged down with the theory of pricing and valuation.

IV. Evaluating the English definition of 'inside information'

The English law defines inside information as such in a very abstract manner which is in accordance with the European Directive. At first sight, no guidance is given as to the informational contents, thus, on principle, it encompasses market information as well as company data. The definition is also sufficiently broad to encompass two conceptual approaches, namely 'functioning of the market' and 'investor protection'.

Conceptually, it is to be noted that the confidentiality requirement has gone. The underlying idea of the definition is therefore not to protect information as an asset of the company (so-called business property approach). The main issue has been the definition of the element 'made public'. The outcome is to some extent in contrast to the approach chosen by the

765 426 US 438 (1976).

766 Australian Corporation Act 1989, s 1002C, inserted by Sched 4 to the Corporation Legislation Amenment Act 1991; for the considerations which lead to the changes to previous rules see Tomasic, 'Insider trading law reform in Australia', (1991) 9 Comp and Sec Law Journal 121; see also Baxt/Maxwell/Bajada, 'Stock markets and the securities industry, Law and practice', 3rd edition, Sydney, Melbourne, 1988 at 228 et seq.

767 Sensational?, one is inclined to ask.

768 Rider and Ashe op cit at 38.

769 Rider and Ashe, idem at 37.

770 Op cit at §12.22.3, and at 12.035.

Directive, and will probably result in various problems concerning the interpretation of the statutes.

To start with, it is important to note that in terms of the English definition of inside information, 'price includes value'. Unlike all the other legislation examined herein, this element refers to the importance of the informational contents, yet without providing any specified contents. Nevertheless, it is certainly appropriate to take this equation into consideration when interpret ing 'price-sensitivity'. This directs the attention away from the mere price reaction.

Price reactions may occur immediately after the release of new information; and yet they are always difficult to measure, because usually more than one piece of information contribute to a price shift. Other factors, such as the general market situation, or the previous performance on the leading Stock Exchanges of the world (ie New York, Tokyo, Frankfurt, London) are also important factors. And even where one observes a change in the share price that can be related to a single news item - how much change would amount to a 'significant' effect on the share price? 5%, 2-3%? And what percentage is really significant to the often quoted reasonable investor? We simply do not know. This has to be considered in every case brought against an insider.

Once the importance of the information is accepted as a more valuable criterion, 'price-sensitivity' can be interpreted with more clarity: the concept becomes open to certain lists of potential inside information. The third part of this study undertakes to enlist some of the most important types of information.

The 'value'-approach will also help identify the subjective evaluation of the information by insiders. Once information appears in a model-list of valuable information, it becomes easier to establish that a transaction was based on a particular information. And even without such a list it is easier for the courts to evaluate the importance of information in terms of their 'value' for the company. Here the English law has chosen a subtle and at the same time practical approach which will help resolve some of the uncertainties arising from the word 'price-sensitivity'. As we will see below, the German legislation has unfortunately left this point open.

It would have been preferable to say, though, that news published outside the UK *is* 'made public' and not merely that such information 'can be treated' as made public. Whenever news about an international company is published on a foreign market (according to their publication rules), the price adjustment normally takes place all over the world.[771] Hence this part of the definition is defective. This leads us to the evaluation of the element of 'made public'.

The definition of 'made public' in the English law must be criticised because insiders are offered too many defences with regard to this element of the definition. The law provides too many situations where information 'may be regarded as made public', although, in fact, it is not yet published. This seems to narrow the scope of the prohibition unnecessarily. The more skilled the insiders amongst the City people are, the more easily they can violate the rules without being caught.

The textual fault is that the publication requirements of the insider trading provisions are not in line with the publication rules in general. It is submitted that it is too difficult to prove mens rea in cases where this element becomes an issue. In the case of s 53(1)(b) of the CJA 1993, for instance, it appears that it is far from clear when an individual is able to prove that he 'believed' the information was 'disclosed widely enough'.

To a similar extent it remains unclear when and how the insider can show that he would have dealt in securities whether or not he had been in possession of the information. If the insider had dealt anyway, he would have done so without the intention of using inside information. In terms of the law he would not have dealt in order to make profit (or avoid a loss) *on the strengh of* inside information. The prosecution must also establish when the information is 'readily acquired by those likely to deal', cf s 58 (2)(c) of the CJA 1993. This formulation confuses rather than illuminates.

The new definition of inside information has altered the position on the question of 'timely dealing', because it categorically states that information 'is made public', if it is published in accordance with the rules of a regulated market. Once it is published, an insider can deal even if the market has not had any time to absorb such information.[772] This approach treats insiders in a friendly manner, and is thus apt to avoid uncertainties created by vague publication requirements eg in the South African law.

Yet the English definition goes beyond this, providing for various

771 Tippach op cit at 85 et seq.

772 Hannigan op cit at 70.

circumstances in which the information 'may be treated' as made public even though it is not officially available. Hannigan[773] asks 'why was this section included?', and then goes on to suggest that 'its effect may be simply to highlight the uncertainty as to whether or not information is public, and that in itself may make prosecutions more unlikely'.[774] It is submitted that, examining the various elements of 'made public', we can detect the considerable influence exercised by the City to bend the rules in accordance with their needs and to their benefit. At closer examination of the situations depicted in s 58(3)(a)-(e) of the CJA 1993 we find that the essence of the provisions is that they benefit[775] financial service people who are next in line to gain access to information before the gneral public does.

The provisions bring about much uncertainty because the decision whether the information may in a particular case be treated as made public is left to the discretion of the courts. It is submitted, however, that this uncertainty will be tackled in favour of these financial service people, because it is difficult to prove men´s rea with regard to *non-public* information, once it is accepted that the information 'can be treated' as made public.

The same tendency underlies s 58(2)(c) of the CJA 1993 according to which information is made public if 'it can be readily acquired by those likely to deal in any securities', a formulation which again extends the regular publishing rules in favour of the City people. Wotherspoon[776] is probably right to suggest that, on behalf of this alternative, the assiduous investor is finally given the opportunity to act more safely. Both alternatives (ie 'can be treated' and 'readily acquired') can be criticised because they open up special defences to skilled persons. All this is brought about by the unconvincing definition of 'made public' that gives no further guidance for the application. The discretion lies with the courts. But to make proper use of such discretion it would have been helpful if the legislator had provided an identifiable underlying concept of insider

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773 Op cit at 72.

774 Idem, at 72.

775 The interpretational approach to determine those who profit from a certain regulation was first suggested by Stigler, 'The theory of economic regulation', Bell Journal of Economics and Management Science 2 (1971) at 3; in an insider regulation context see Manne (Cato Journal) at 941 et seq.

776 Op cit note at 423.

trading. Unfortunately, there is none.

The underlying concept is certainly not to strengthen investor confidence, because existing informational asymmetries are maintained through the laxity of the element of 'made public'. Nor can we trace the 'business property approach' as an underlying concept, because the confidentiality requirement of the old Act is gone. Is market protection the new English concept, such as it was envisaged by the Directive? Certainly not, for of all the market participants (ie companies, investors, insiders, financial business industry) only the financial service people are given further protection. They are the second best informed market participants. Given the high degree of protection offered to them, they will be able to exploit inside information more than anybody else. Hence the redistributional effect of insider trading prohibitions is almost entirely in their favour, and not, for instance, in the favour of the small investors.

The absence of an underlying concept will pose enormous practical problems. If the intention of the law is not readily apparent, on what concept will the courts base their decision? Given this vagueness it may be doubted whether the English insider provisions will effectively help deter insider trading. It is likely that cases will not end with a conviction, but, instead, in a renewed attempt to clarify some or other point by the law, perhaps under less influence from the City.

E. The German definition of 'inside information'

Inside information is defined in § 13(1) Nr. 3 within Artikel 1 of the

> 'Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften'[777]

(ie Zweites Finanzmarktförderungsgesetz), whose 'Artikel 1' is the 'Gesetz über den Wertpapierhandel' (engl.: Securities Trading Act), hereinafter abbreviated as 'WpHG'. The German[778] wording is:

> (1) Insider ist, wer
>
> 1. ...
> 2. ...
> 3. aufgrund seines Berufs oder ... bestimmungsgemäß
>
> Kenntnis von einer nicht öffentlich bekannten Tatsache hat, die sich auf einen oder mehrere Emittenten von Insiderpapieren oder auf Insiderpapiere bezieht und die geeignet ist, im Falle ihres öffentlichen

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777 BT Drucksache 12/6679 of 27 Jan 1994; see the excellent detailed analysis provided by Kümpel, 'Bank- und Börsenrecht', Köln, 1995 at 1156-1227; see the detailed article by Assmann, 'Das neue deutsche Insiderrecht', ZGR 1994 at 494; for the view of a German practitioner see the article by Peltzer, 'Die neue Insiderregelung im Entwurf des Zweiten Finanzmarktförderungsgesetz', ZIP 1994 at 746.

778 English translation taken from Mohr, 'Insider- und Börsenrecht, German insider and stock exchange law', Frankfurt/M, 1994 at 80 et seq.:

(1) An insider is any person who

1. (...)
2. (...)
3. by reason of his profession (...)

has knowledge of a fact which is not publicly available, relating to one or more issuers of insider securities or to insider securities, and which is prone, if it were to become publicly available, to substantially influence the market price of an insider security ('insider fact').

'Prone' must be understood in the sense of being 'generally suitable or fit' to influence. It must, however, be clarified that the information only needs to be likely to be 'prone' as opposed to 'prone in relation to the particular case' in the sense that it would be necessary for an actual price shift to have taken place.

General note: The translations of the German texts cited are taken from Mohr, 'Insider- und Börsenrecht', so long as no other reference is given.

Bekanntwerdens den Kurs der Insiderpapiere erheblich zu beeinflussen (Insidertatsache).

The technique chosen by the German legislator is the definition in brackets, which means that the term which is defined appears in brackets at the end of the definition. The formulation is quite similar to the one in the European Directive with two exceptions: the first is that § 13 WpHG speaks of 'Insiderpapieren' (ie 'insider securities') instead of 'securities'; the second is that the term 'information' has been replaced by 'Insidertatsache', dropping the word 'precise' which is used by the Directive. The hypothetical character of the European definition has been maintained without any attempt to provide further guidance as, for instance, in the English law.

I. Elements of the definition

It is necessary to consider here the German definition of the insider: According to § 13(1) WpHG, an insider is 'a person who, as a member of a supervisory board, ... *has knowledge* of inside information'. From this one must conclude that there is no 'insider per se' under the German statutes,[779] not even the member of a supervisory board is, by virtue of his position, an insider, unless he has inside knowledge.

Hence an insider can only be a person who has inside information,[780] irrespective of his or her profession. The interpretation of the term 'insider' therefore depends on the definition of inside information.

1. 'Insidertatsache' (engl.: 'insider fact')

The term Insidertatsache is difficult because the noun 'Tatsache' is not easy to interpret. It is typical of the German language to construct a new noun from a noun and an adjective.

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779 But see, for an interpretation of the Directive which accepts the 'per se-insider', Wymeersch op cit at 70 who contends that 'there will be no strict requirement to prove their possession of that particular information'. Since the criminal sanctions do not fall within the competence of the European Legislature, the interpretation of criminal statutes must exclusively relate to national courts. Therefore, the view expressed by Wymeersch is not acceptable.

780 Assmann, 'Das künftige deutsche Insiderrecht (II)', AG 1994, 237 at 241.

a) The 'Tatsache' as a result of transposing 'precise (see the Directive) information' into German domestic law

'Tatsache' (engl.: fact) is a difficult term in German jurisprudential language. It has to be distinguished from personal judgements and evaluations, a task which at times poses severe problems. For instance, would it be fact or judgement to assert that 'merchant A pays slowly'?

A 'Tatsache' must be provable or at least be open to empirical analysis. It must therefore be 'precise', although this adjective is not explicitly used in the provisions. The courts would decide that a statement contains a 'Tatsache' rather than a judgement, if the validity of the contents can be ascertained, in other words if it can be proved either true or false.[781] Dealing on a 'true tip' (ie without knowledge of the inside information as such) is therefore not caught within the legislation (see below).

It would, however, be a mistake to confine the meaning of 'Tatsache' to mere factual events[782] as the translation might suggest. The term would seem to include, for example, predictions of the earnings of a company, although they can only be realized in the future. And this wider interpretation makes sense: since most of the pricing of stock is based on expectations, a 'pure facts' interpretation would narrow too much the scope of potentially relevant information.

Kümpel[783] refers to 'eingetretene' (engl.: something has already happened) Tatsache as the best interpretation. Nevertheless, he subsumes *bevorstehende* Zahlungsunfähigkeit (ie 'impending' insolvence) under the term. The latter is certainly correct from the point of view of relevance for the stock price, but difficult with regard to 'eingetretene' Tatsache. Kümpel[784] is of the opinion that the decision whether an impending insolvency can be qualified as an insider fact depends on whether or not the critical financial situation can still be improved. This is correct as long as the word 'insider fact' is interpreted in line with the disclosure

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781 See the decision in BGH NJW 1983 at 2248 et seq.; see also Erman-Schiemann, Bürgerliches Gesetzbuch, § 824, no 2.

782 This was, however, the opinion of Claussen op cit in his comment on the possible transposition of the Directive into German domestic law.

783 Op cit (Bank- und Börsenrecht) at 1166.

784 Ibid, at 1166 et seq., referring to BT-Drucks. 12/6679 op cit at 48.

requirements,[785] because such a financial situation would certainly have to be reported to the Stock Exchange Supervisory Board.

Just like the English law on insider trading, the German law has omitted to explain more precisely what can be regarded as potential information. No further guidance as to what can be the possible content of the information has been provided. The range of possible solutions is thus far reaching. The former German Insiderhandels-Richtlinien (IHR), for example, provided a combination of a detailed list of possible insider facts and a general clause (dt.: 'Generalklausel')[786]. Such a general clause was used in most European countries before the adoption of the Directive.[787]

No information is an 'Insidertatsache' under the German law, if it is based exclusively on information which is already publicly known ('öffentliche Tatsachen').[788] It has to be noted, however, that news based on information which will be published only at a later stage, is caught within the definition.[789] This part of the provision has been copied from the preamble to the Directive. It provides protection for financial analysts. This makes sense because skilled work on publicly available data is generally protected.

b) <u>In particular: the element of 'precision'</u>

The element 'precise' of the Directive is now embedded in the word 'Tatsachen' (facts). Commentators agreed that 'information' must contain a 'factual' nucleus ie that mere speculation or supposition would not fall within the definition. It was argued that this element also intended to exclude stock exchange rumours[790].

Apart from this readily apparent interpretation, the German literature did

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785 See Tippach op cit (Insider-Handelsverbot) at 135 et seq.

786 Rümker, 'Zur Auslegung der Insiderhandels-Richtlinien', BB 1972, 1208 at 1209.

787 Wymeersch op cit at 115 et seq.

788 § 13(2) WpHG.

789 Assmann op cit (1994 AG) at 245.

790 Claussen op cit at 276; for the point of view of a German practitioner see Grundmann, 'Neuregelung des Insiderhandels-Verbotes', ZKW 1992, 12 at 13; from an international point of view see Mann and Lustgarten, 'Internationalization of Insider Trading Enforcement', in: Hopt and Wymeersch op cit (European Insider dealing) 339 at 374.

not know what exactly to make of the element 'precise' in the Directive. For instance, must the information be 'true' or 'correct'? A trader who knows that new information is 'wrong' (eg only a rumour) would certainly possess valuable and 'precise' information.[791] If this knowledge stems from an inside source, the insider is able to profit from it. It is hence submitted that 'precise' does not mean 'probable' in the sense that it is likely to become reality; rather the term 'precise' means that an intention must be 'precise'. Take, for example, the price per share of a public offer. It is not necessary that the public offer is really made, as long as there is an intention to make an offer at a certain price.

c) Market information

The 'Tatsache' must relate to 'one or several issuers or to one or several securities'. This additional[792] element enables us to differentiate between company information which relates to issuers, and market information that relates to securities.[793] It would seem that market information which relates to securities generally does not fall within the definition in the Directive.[794]

This view[795], however, is disputed, directly by Assmann[796], and indirectly by Hopt[797], both of whom think that all types of market information can be seen as inside information as long as they have a substantial price impact. Their opinion is based mainly on a teleological approach according to

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791 Grunewald op cit at 132.

792 The addition of this element requires a wider range of data to be covered by the term, see also Kümpel op cit (Bank- und Börsenrecht) at 1168.

793 See for a general overview Branson (Insider trading II) at 414; cf the analysis by Fleischer/Mundheim/Murphy op cit at 799. Their view is, however, based on the old 'disclose or abstain'-rule, and can therefore not be applied to our problem.

794 The English legislator has accurately transformed the Directive in this regard.

795 Which has received approval by Caspari op cit (ZGR 1994) at 540, who was in charge for the 'Regierungsentwurf' (ie the Governmental draft law).

796 AG 1994 at 243, and in Assmann/Schneider op cit (Wertpapierhandels-Gesetz) at 113 et seq.; see also Kümpel op cit (Bank- und Börsenrecht) at 1169 who is criticised by Assmann in Assmann Schneider op cit (Wertpapierhandelsgesetz) at 114 for 'being unclear'.

797 Hopt, 'Rechtsprobleme des europäischen und deutschen Insiderrechts', BFuP 1994, 85 at 90.

which dealing on any informational advantage is a wrongful act, irrespective of the nature of the information.[798] Yet, since the objective wording is a strict interpretational boundary under the German Penal Code, their view is probably not acceptable, because there is no room for teleological interpretation.

The German text 'oder auf Insiderpapiere' (English: 'or insider securities') deviates from the Directive and is sufficiently broad to cover all types of market information: shares, options, bonds, futures, warrants etc. Textually, we can observe that the original (ie European) distinction between general data (eg about markets, currencies, political events) and data which relates to a definable circle of securities (eg information about a specific branch or about trading volumes in a group of shares) is gone. In this regard the German version of the transposition of the Directive differs from the English one.

It is submitted that an interpretation which conforms with the wording of the Directive and excludes information relating to securities in general is more appropriate. Narrower interpretation is also the principle of priority of the European law. On this principle, it is generally accepted that the transposed European law, which is based on a Directive, has to be interpreted in the light of that Directive.

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798 See Assmann op cit (1994 AG II) at 243 et seq.

2. 'nicht öffentlich bekannt' (engl.: not publicly known)

The element of 'not publicly known' is basically the same as in every insider law and describes no more than the synonym of 'inside'. It does not, however, provide any indication as to the contents of the information. Also, it contains the same circular definition as the European, the South African (and presumably all insider trading prohibitions), namely that 'public' is no more than the opposite of 'inside'. No concept can be derived from the text, neither economically in the sense that information is no longer 'inside' where it is incorporated in the new price; nor, juristically, in the sense that publishing rules must have been complied with.

a) Terms similar to inside information

Terms similar to 'inside information' are used in the German Aktiengesetz (AktG, engl.: Stock corporation Act) and in the German Criminal Code (StGB)[799]: these are 'confidential information' and 'secrets'. None of these can, however, determine the meaning of 'inside' information.[800] Whenever confidentiality is or was an element of a definition, this is (or was) expressly mentioned by the law.[801] Neither the Directive nor the WpHG require the information to be confidential or secret. This element has therefore been dropped. It is submitted that the term 'non public' in the German insider trading law does, conceptually, not intend to protect fiduciary relationships or business properties.

b) Different views

Subsequent to the adoption of the Directive, two different interpretations have been submitted. The first is that information is 'publicly known' when published through mass media (eg radio, television, press) thus ensuring that small investors are aware of the information.[802] This , however, was clearly not the intention of the Directive,[803] and therefore this view has to

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799 See §§ 93, 404 AktG, 203 et seq. StGB, see also § 333 HGB (Commercial Law Code); see Assmann op cit at 241.

800 Assmann, idem at 241.

801 Cf No 1 of the former (self-regulatory) IHR.

802 Cf Claussen op cit at 276; cf also Schödermaier/Wallach op cit at 123.

803 Tippach op cit (Marktdaten).

be rejected.

The second interpretation is that the information must be available either through the mass media, tickers[804], dpa or Reuters[805]. The legislator in its 'Begründung', ie the official grounds and substantiation of the new law, has created the term 'Bereichsöffentlichkeit'[806] (ie 'public' in a sector of the public). This concept is far narrower than that of the public at large and seems to enocompass only professional market participants.[807]

It is important to remember that the intentions of the European legislator would prevail over national legal reasoning and, what is more, that the courts in Germany are in no way bound by the official grounds for the legislation (Legislativ-Begründung). Nevertheless, such an interpretation seems to be in line with the conceptual purposes of the law. Informational imbalances are a structural element of entrepreneurship; and of every private business raising funds on public securities markets in general. Thus it is never possible to attain an equal treatment of all market participants - which remains a vain ideal. In economics, such ideals had to be rejected as 'nirvana approaches'[808]. An important point to consider, however, is the question whether it is the financial services people who will benefit from the 'Bereichs-Öffentlichkeit approach'.

c) Analysts, and the problem of press conferences

Given the preferential treatment of the financial services industry, it is not surprising that in the German literature it is an issue of particular interest whether, in situations where analysts are concerned, the term 'public' should be interpreted in a different way. Some writers suggested[809] that analysts should be required to wait 24 hours after the publication of the information on ticker before they can pursue their transactions.[810] This

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804 Hopt op cit (ZGR 1991) at 30.

805 Kümpel op cit (Bank- und Börsenrecht) at 1171.

806 Regierungsentwurf (engl.: draft law submitted by the Government) für ein 'Zweites Finanzmarktförderungsgesetz', BR Drucks. 793/93 presented 5 Nov 1993 at 46.

807 For attempts of explanations see Assmann op cit at 242; and Tippach op cit at 81 et seq.; see also Weber, 'Das neue deutsche Insiderrecht' at 163.

808 See Part I of this study.

809 Claussen op cit at 278, his suggestion for a Code, namely § 3(1) Nr. 2.

810 See also Hopt op cit (1991 ZGR) at 30.

view must be rejected for being contrary to the Directive.[811]

Another problematic issue is whether information can be regarded as 'publicly known' when released at a (generally accessible) press conference. Assmann[812] thinks that even a publicly accessible press conference is not an appropriate means of making information public. There is only a limited number of people who can attend such a press conference. Thus information 'released' there cannot reach the '(relevant) sector of the public', which constitutes 'Bereichsöffentlichkeit'. Consequently, new data must be filed on ticker tape before transactions may be carried out.

3. 'geeignet, den Kurs ... erheblich zu beeinflussen' ('prone[813], if it were to become publicly available, to substantially influence the price of an insider security)

The last requirement of § 13(1) WpHG is that the information must 'be prone to substantially influence' the market price of an insider security (ie shares, options, futures, warrants etc), if it 'were to be made public'. Much attention has already been given to the requirement of price sensitivity. This element of the definition has raised a lot of interest because it is particularly imprecise. Also, it must be measured ex post, ie after the publication, which makes it a lot more difficult to handle.

The issue in the German law is, amongst other things, that in penal law the objective wording must be extremely clear and unambiguous because any analogous interpretation - including the theological approach favoured by the Directive and by the European Court of Justice is strictly forbidden by Artikel 103(2) Grundgesetz (engl.: the German Fundamental Law).[814] Thus

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811 See Assmann op cit at 241.

812 Idem, at 242.

813 See the translation submitted by Mohr op cit.

814 See BVerfGE 25, 286; see BVerfGE 64, 389; the main historic reason for this requirement is the 'Analogienovelle' under the NS regime which required analogy to the disadvantage of the accused.

A perfect example of how strictly the rule can be applied is the early decision RGSt 29, 111 (116) in which a conviction was reversed, because the defendant had stolen electric energy which was not subsumable under § 242 StGB which requires that a 'thing' is stolen. A thing is conceived to be solid, thus energy did not fall under this the meaning of 'geeignet' must not remain vague.

For example, it would seem to be unacceptable under the German insider law to adopt the materiality definition prevalent in the United States without major modifications. Materiality in the USA[815] today is an open-ended concept[816] with enormous flexibility. Particularly when so-called soft

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definition - at that time it was held that electricity could also be 'fluid'. This led to the adoption of § 248c StGB 'misaproppriation of electric energy' on the 9th April 1990; see also the decision in RGSt 32, 165 (167). This interpretational limit does certainly not apply less strict since it was expressly inserted in the Grundgesetz.

It is important to note that this strict interpretational limitation to the objective wording of the law is specifically German, but see for this approach in the South African criminal law Snyman op cit (legaliteitsbeginsel). In England, however, the view is different, following the influential dicta of Lord Reid in DPD v Otewell [1970] AC 642 at 649. With regard to insider trading, the House of Lords emphasized that it is the objectives and not the letter of the Act which should determine the scope of the regulation, cf A-G´s reference (No 1 in 1988) [1989] 2 All ER 1 at 5 et seq.

It has to be noted, however, that despite frequent allusions to the intention or intent of the legislature, the trouble about judicial appeals of that kind is that they appear to be highly ambiguous, see Bankowski/MacCormick, 'Statutory interpretation in the United Kingdom', in: MacCormick/Summers, 'Interpreting statutes - A comparative study', 359 at 386 et seq.; the articulation of the approach to interpretation in A-G´s ref (No 1 in 1988) makes it important to emphasise that the 'meaning in context' rule may not be the same as what is sometimes called the 'plain meaning' rule. It might be argued that wherever a case goes to appeal about the meaning of a word or words in a statute, there is bound to be a possible disagreement about the meaning, and therefore to proclaim that one meaning is 'plain' contains its own refutation, see Ashworth op cit at 428; yet one should bear in mind that there are some approved ways of ascertaining legislative purposes, Ashworth, idem at 430 et seq.

815 See the excellent article by Brudney, 'A note on materiality and soft information', (1989) 75 Virginia Law Review 723 whose suggestion is that interpretation should indeed vary with the context in which the information is placed, idem at 738. In terms of the German Penal Code, however, such a view would have to be rejected because it would not be generally applicable, it would seem to lack the precision which is required by the Grundgesetz.

816 See the Basic Inc. decision, 108 S Ct at 987 et seq.

information[817] is at issue, the decision of the courts is not easy to foresee. This effect, coupled with the principles applied by the SEC,[818] namely that all information which may influence the investment decision of the other party must be disclosed,[819] leads to a subjective definition.

Such a concept may also result in a different scope of information depending on the co-contractants. In other words, the importance of an information is defined by the personality of the parties involved. For instance, a professional analyst may need less substantial information than a private investor to buy the 'right' security. US courts define information as 'altering the total mix of information'[820]. This approach would not be acceptable under the German penal provisions.

Another subjective test, which was applied in the Texas Gulf Sulphur case[821], is the so-called 'proof of the pudding'-test, which defines inside information as information which caused insiders to carry out their transactions. The 'reasonable investor'-test which is normally applied by the courts, is subjective, too.[822] All these subjective interpretations seem unacceptable for the interpretation of German Penal provisions.

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817 See Brudney op cit at 757 (ie information about merger transactions which will be carried out in the near future).

818 See for instance Cady, Roberts & Co., 40 SEC 907 (1961).

819 Idem, at 911; see also the formulation in Texas Gulf Sulphur op cit note 1 at 844: 'facts which affect the desire of investors to buy, sell or hold'.

820 See Basic, 108 S. Ct., at 983; identical formulation in TSC Industries v Northway, Inc 426 US 438 (1976) at 449.

821 Op cit note 1.

822 Texas Gulf Sulphur at 849: 'facts which, if disclosed, would be reasonably likely to have a substantial market effect'; see also List v. Fashion Park, Inc 340 F 2d 457 (2nd Cir1965) at 462; but see also TGS op cit at 849; Basic Inc v Levinson, 108 S Ct 978 (1988) at 987: 'material upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company activity'. Yet, is this precise enough? A German Court would probably doubt that.

a) Different opinions on the interpretation of 'price-sensitivity'

Although the view has been expressed that the determination whether information is price-sensitive would depend on the facts of each individual case[823], it is obvious that in practice more concrete points of orientation[824] are needed. This is true not only for the insiders themselves, but also for the public prosecutor, and the supervisory bodies on the stock exchanges.

At this stage it is even doubtful whether the wording of the law is consistent with the German 'Bestimmtheitsgebot'[825] (ie nulla poena sine lege, see Fundamental Law, Article 103 II GG), creating the obligation for the legislator to be absolutely precise. If Penal law is not precise it is declared invalid. Thus far, the following three interpretations have been submitted.[826]

aa) 'Actual price shift' of a certain percentage (%-approach)

Claussen[827] submitted that the requirement would be fulfilled in situations where the security price actually changes. He suggested different percentages between 15%[828] and 10%[829]. This means that the information would fall within the definition only if the price of the security should change by 10 (or 15, or 20, or 5) % on release of this information.

An argument in support of this interpretation could be the certainty it might create. The courts can easily compare the last price before the announcement of the new information and the first 'new' price. If, and only if, a 5% (or other percentage specified by the law) price shift occurs, then the information is within the scope of the definition, wheras if it fails to

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823 BT-Drucks. 12/6679 at 48.

824 Claussen, 'Das neue Insiderrecht', DB 1994, 27 at 30; see Hopt op cit at 32; see Kümpel, 'Zum Begriff der Insidertatsache', WM 1994, 2137 at 2139.

825 See for this problem Kümpel op cit (Bank- und Börsenrecht) at 1180, referring to Tippach op cit (Marktdaten) and Peltzer op cit (ZIP 1994).

826 For an overview see Kümpel, idem at 2137, who rejects the %-approach.

827 Op cit (ZBB) at 279; see his suggestion for a transformation of the Directive, in particular § 3(1) No 4; interestingly, an alteration of security prices as a criterion for the courts is also envisaged by Hopt op cit (ZGR) at 32.

828 Op cit at 278.

829 Op cit (DB 1994) at 30.

change the price by 5% on the very day of the publication, it is not. Firstly, this interpretation is certainly contrary to the objective wording of the text 'geeignet', which requires that the information is prone or can generally be expected to produce a price change, not, however, that it actually does so.

Secondly, this interpretation makes no sense economically, because often the impact of new data is accurately anticipated by market participants, and thus the price shift on the day of the publication is considerably lower than the whole impact of the information.[830] The 'whole impact' is, however, meant by 'geeignet'.

Thirdly, if information can be subsumed under the definition only on release (ie later than the transaction takes place!), it would produce retroactive effect - and that constitutes a clear violation against the abovementioned German principle of strict and objective interpretation of penal law. For these reasons Claussen´s view has to be rejected.[831]

bb) 'Plus'- or 'Minus' (+/-) - announcements

Other authors are of the opinion that information is 'geeignet', ie price-sensitive, if the official (or, sometimes an independent person) market maker (dt.: Makler) who deals in security which the information relates to, adds a '+' (plus) or a '-' (minus) to the first quotation of the day. According to the rules of the Stock Exchange this means that the 'Börsenmakler' *expects* a certain price alteration for this share to happen during the day. The minimum price alteration which he must expect (taking into consideration the orders which he already has), must amount to 5% in a share or 1,5% of the nominal value of a bond.[832]

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830 This process of incorporating new data in share prices is very well depicted by Gilson and Kraakman op cit at 572 who argue very interestingly that information which is accessible to significant portions of the analyst community can properly be called 'public' even though it is manifestly not.

831 For a detailed analysis of the arguments against this view see Tippach op cit at 121 et seq. For arguments against Claussen´s view see also Kümpel op cit (Insider-Tatsache) at 2140 et seq.

832 See Assmann op cit (Das neue dt. Insiderrecht) at 515; Assmann in Assmann and Schneider op cit at 120 et seq.; Kümpel op cit at 2140 et seq.; see also Caspari, 'Die geplante Insiderregelung in der Praxis', ZGR 1994, 530 at 541; it is interesting to

An argument in favour of this interpretation might be that the official broker is a market participant whose pricing and whose transactions directly reflect the opinions of the market.[833] It is worthwhile recalling here that, economically, the market maker might be the most important market participant with regard to insider trading prohibitions because he is the most likely to suffer losses from insider trading. Also, this addition on the quotation board would signal price shifts in a way which allows other traders to rethink their own investment strategies.

At first sight, this does perhaps sound convincing. Yet, such an interpretation would create enormous difficulties. First of all it has to be noted that the '+/-' theory is quite similar to the above 'percentage interpretation' in that the inside quality of the information would be recognized only retroactively, that is on publication. The insider may have carried out his transaction (or sold the information) 4 or 5 weeks before this happens without ever knowing that, in fact, he dealt on 'inside' information.

Secondly, it would turn out to be difficult for the prosecution who has to prove men´s rea. How could they possibly show that the insider 'knew' that the broker adds '+' or '-' to the quotation on day X of the publication. On the contrary: the insider wants the price to shift gradually, so that he cannot be detected at all. Yet, in any event, it is indispensable for the prosecution to link the information to the insider´s subjective evaluation of it.

Also, what should happen if the insider dealt in options without even thinking of the price shift of the share? How should one decide in cases where the insider sells the shares (which he bought on the strength on inside knowledge) before the information is published (because the share price has already reached the level which the insider expected)? And what happens if the broker simply makes a mistake and forgets to add signs on the board, or misinterprets the volumes of orders he has got in the early morning? All these are possible cases of insider trading where the +/- theory must fail.

Another decisive counterargument is that some very important information is incorporated into the share price only over time. For instance, it took the Frankfurt market about two weeks fully to reflect the acquisition of Rover

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note that Mr Caspari was responsible for the submission of the draft, ie the 'Regierungsentwurf' op cit.

833 See BT Drucks. 12/6679 at 47.

by BMW. At times, major price changes are not completed within a day, so that no '+/-' ever appears on the quotation board, although the all-inclusive price change is important. Thus, although '+/-' might give some indication of trend, it can never amount to an interpretation of price sensitivity in the sense that it must be fulfilled as a condition to subsume a piece of information under the law. Nor can it be sensible that dealing on the strength of secret knowledge is not insider trading, when the price shift takes place before the information is released. The latter is, in fact, how information is economically incorporated in prices. The suggested interpretation is therefore also not in line with economic findings.

cc) Harmonisation with European publication rules

Both the above views exhibit another shortcoming. Insider trading prohibitions should be closely connected to publication rules. Particularly in the United States juristic doctrine it is accepted that prohibiting insider dealing will enhance prompt and early disclosure (thus: 'disclose or abstain').[834] This interconnection of two sets of rules is not taken into consideration by either of the two above interpretations.

Whether information results in a pre-determined price shift may become important only where civil action is brought against the insider. In that case one needs to measure the damage suffered by the other party to an insider transaction. Since neither the European, the English[835] nor the German insider laws stipulate such a civil liability, this actual price shift is not important. I have therefore submitted elsewhere[836] that the European, and consequently the German laws are open to an interpretation which links the definition of 'information' to the publication requirements on a European level.

Where information is required to be published under the European rules on publication, it should be deemed inside information irrespective of the price

834 See for instance Speed v Transamerica Corp 99 F Supp 808, 829 (D Del 1951); Cady, Robert & Co., 40 SEC 907 (1961) and, most importantly, in the Texas Gulf Sulphur case op cit note 1.

835 See, however, McVea, 'Fashioning a system of civil penalties for insider dealing: Sections 61 and 62 of the Financial Services Act 1986, Journ of Business Law, 1996 at 344, as the main English proponent of civil remedies against insiders.

836 Tippach op cit at 135 et seq.

shift achieved on its release. In terms of European harmonisation this would also bring about further legal assimilation of the Directive through the interpretation of national courts. Another advantage of this approach is that it can be further developed and refined by means of European publication requirements. Whenever the European law adds a new type of information that has to be published, the list of inside information is also extended.

dd) Hopt´s opinion

Another view has been suggested by Hopt[837], who prefers to interpret this element as an objective market impact test. The important factor would then be whether or not the information is *objectively* prone to influence the price.[838] The price shift potential is decisive, not the actual price change.[839] Referring to the 'potential' is certainly correct. This test implies a reference to the price reaction, not, however, to the informational contents. Hopt[840] suggests that his interpretation is contrary to the 'reasonable man'-test, according to which the evaluation of a 'normal' investor leads to a classification of the information as price-sensitive.

An objective 'market impact' test raises several problems. Firstly, it implies that a price change can be linked to a particular piece of information. But it often occurs that a variety of information is released on the same day so that it is not possible to determine the specific part of the price shift which is due to each information. Also, there are other influences such as the 'general atmosphere' on the Stock Exchange, which make it impossible to relate one specific information to the total price shift. What is more, a convincing economic theory which would explain the price determination process under the realistic assumption that expectations are heterogenous, has not yet been developed.[841]

Secondly, the same type of information can result in different price

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837 Op cit (1991 ZGR) at 32.

838 Idem at 32. A similar view is expressed by Kümpel op cit (Bank- und Börsenrecht) at 1174, who says that the primary interpretational concern would be 'die Höhe des zu erwartenden Kursausschlages', ie the objective ex ante potential price impact.

839 Idem at 32

840 Idem at 32; it is interesting to note that English commentators explicitly try to apply the reasonable man test, see for example Rider and Ashe op cit (Insider crime) at 37.

841 Schneider op cit at 1434.

reactions depending on a variety of factors.[842] It makes a big difference whether publication is in an official organ or an obsure journal.

Thirdly, the objective price potential of information needs to be based on empirical research.[843] Since *specific* information is singular and does not occur periodically, it is too difficult to furnish empirical data. Information which is *generally* prone to change share prices cannot be evaluated in the context of each individual case. Hopt's interpretation must therefore either accept that a certain percentage of price movement suffices (which Hopt[844] finally admits), or one must find new criteria for the 'substantial influence', as long as such empirical data on price reaction is not available. Hopt did not, however, suggest any such new criteria.

Fourthly, even if it were possible to classify the objective market impact of a piece of information, the suggested view does not present a convincing criterion of how to determine the element of 'substantiality'. Would a price change of 3%, 5% or 10% be sufficient? And if so, why? Given all these unresolved problems Hopt's opinion is probably not acceptable.

II. Evaluation of the definition of the 'Insider-Tatsache' (inside information) in § 13 WpHG

It is immediately apparent that the wording of the German insider dealing provisions resembles that of the Directive. It is questionable, though, whether the legislature has actually transposed the Directive into domestic law or whether it has, instead, copied the European source without really incorporating it into German law.

The only readily apparent transposition is the Insider-'Tatsache' which replaces the term 'precise information' in the Directive. Yet, not even this does really take into account the the economics of inside information.

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842 Renner, 'Der Schutz des Kapitalanlegers gegen die Ausnutzung von Informationsvorteilen' at 50 et seq., who points out that there is a number of variables that can, according to the particular circumstances of the stock exchange, provoke price shifts which are not predictable.

843 See Ballwieser, 'Insiderrecht und positive Aktienkurstheorie', (1976) 28 zfbf 231 at 238 and at 240 et seq.

844 Op cit (ZBB) at 279.

'Tatsache' may be interpreted by the German courts[845] as 'fact', thus failing to take into account some of the most insider-relevant information, eg a forthcoming take-over bid. Such a take-over is a future event, a plan, not yet a provable fact which seems to be required by the traditional definition of a 'Tatsache'. The Courts may then refer to the 'fact'/'Tatsache' that a take-over is planned. Yet such an interpretation does not fully take into account the original wording of the Directive (ie 'precise'). Besides, this interpretation blurs a good deal of the precision which the legislator intended to create through the word 'Tatsache'.

On the other hand, clearly, it would seem unwise not to include pre-take-over situations, because they create the largest amount of insider trading possibilities. All this results in much uncertainty for the insiders concerned. It is submitted that the law should clarify that a company's clear-cut intention to announce a take-over, is included in the definition, even though the take-over might eventually not be carried out.

As far as market information is concerned, the wording of the German definition does not correspond to the Directive because 'Insiderpapiere' (engl.: 'insider securities') would encompass all types of market information - as opposed to the Directive which limits the scope to such information which concerns either one or several issuers of securities.

Under the Directive, for instance, Government data, public debt, political news, and information from the Central Statistical Office would be excluded, although they can possibly affect the market as a whole. It is worth discussing at a later stage whether it would be preferrable to include all market information rather than excluding some types. For the German courts, however, it would be possible to deviate from the broader German wording (and apply the Directive), even under the doctrine of the strictly objective interpretation, because this would be a deviation in favour of the defendant. Such deviations are, of course, allowed by the Penal Code and by the Constitution.

No indication at all has been given to the interpretation of the element 'non-public'. This term has simply been copied from the Directive; and the Directive is indeed not very illuminating because 'non-public' is no more than a synonym for 'inside'. Thus, on this point, the law contains little more

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845 Following the view submitted by Claussen op cit (1992 ZBB) at 276 et seq.

than a pleonasm.

The same is true of the approach provided in the official grounds, eg the concept of 'being known by a sector of the public', meaning the Stock Exchange (financial services) people, the so-called 'Bereichsöffentlichkeit'. While this may seem acceptable at first sight, it may eventually result in some serious problems: first of all, it is difficult to determine which persons constitute 'a sector' of the public. This was also a problem under the former English law according to which 'non-public' meant 'not generally known to those persons who are accustomed or would be likely to deal in those securities ...'[846].[847] Instead of learning from the English example, the German law has repeated the flaw. Bearing in mind the intention of the law to protect the market as a whole, it would seem to be too narrow an interpretation to say that 'those persons' are the market-makers.[848] On the other hand, it does not seem correct to say that it is the investing public as a whole who are aimed at by the provision.[849]

Secondly, there is the issue of timing, ie the relevant moment when the people of a specific 'sector' acqire information: would the definition refer to the first moment when the information is acquired, or does it refer to the time when the information has been digested? Clearly, a great number of possible moments are conceivable. This adds to the uncertainty.

Thirdly, 'Bereichsöffentlichkeit' does not take into account the fact that sometimes most of the impact of the information is anticipated by the market participants and is therefore already reflected in the share prices at the moment of publication. Then, however, it no longer makes sense to impose sanctions on the insider, because he could actually make no profit out of a quasi-public information.[850]

Last but not least, the form which the German legislation has given to the element of price-sensitivity has to be evaluated. In this respect it is apparent that a 'transposition' of the Directive in the true sense of that word has not taken place, but merely a reproduction. This is all the more regrettable

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846 Sec. 10(b) of the CSA 1985.

847 Very sceptical as regards this element as such Wotherspoon op cit at 422.

848 Gore-Browne op cit at 12.034.

849 See McVea op cit at 71.

850 See Gilson and Kraakman op cit at 572.

since 'prone to materially influence the prices' is at the heart of the definition of inside information. Two interpretational approaches to this problem had to be rejected: firstly, the one which suggests that an actual price shift needs to occur, and secondly that the information is 'geeignet ...' if, on the day of its publication, the broker who deals the share adds '+/-' to the quotation board.

On the whole the transposition of the Directive is relatively poor. The German legislator has not made use of a proper terminology in that we find English words in the statutes. This is not a fault in itself, because everybody knows more or less what insider dealing means. Yet it shows how new all the concepts are to the German law.

Given the predominance of statutory rules in Germany and the strict interpretational limits in penal law set by the objective wording, the law should have provided more clarity and guidance with regard to the underlying concept. This all the more because, for a conviction under the German criminal law, it must be proved that the concept or value which is protected by a statutory provision has somehow been damaged. For instance, when would the 'integrity of the market' be damaged?

The only excuse for all this is that it was the first attempt made by the German legislator to cope with the insider trading problem, which is admittedly a very complicated matter. Proposals for an amendment of the law can be expected.

Chapter 3: 'Insider' defined

After the discussion of the constituent element of 'inside information', it is now appropriate to examine how the 'insider' is defined in the three laws. This is the second basic problem that must be dealt with by every legislation on insider trading. The concept of this definition determines the circle of persons who, if they are in possession of material non-public information, must not trade on it. One can distinguish between persons who are inside a company, ie the 'classical' corporate insiders, eg directors or employees; and those who are not connected with the company whose securities are affected by the information. We shall now examine the three laws in turn.

A. South Africa

Textually, the South African legal definition of 'the insider' is the broadest of the three enactments. Yet, as we shall see, it lacks conceptual coherence and is therefore not likely to be very efficient.

I. Considering the changes to the previous law

Sec. 233 of the 1973 Act as originally enacted proceeded by enumeration in order to define the insider. 'Every director, past director, officer, or person who has knowledge of ...' would be held liable if he deals on inside information. These insiders were more closely defined in s 229 and s 1 of the Companies Act. Because of the major extensions brought about by the 1990 Act there is little point examining those provisions in detail[851]. It should, however, be noted that, in addition to those persons, s 231(1) provided that in case of proposed transactions of the company, directors 'shall forthwith[852] by resolution determine which officers of the company, whose names have not already been entered in the register (ie of insiders' interests), are to be taken to be possessed ... of that information in the course of their respective duties and shall cause the names of such officers to be entered in the said register'.

Thus persons within the company were at the heart of the prohibition. As a

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851 See Rider op cit (1977 SALJ) at 442 et seq.

852 Directors who fail to do this are guilty of a criminal offence, cf s 232(2).

result, the scope of 'insiders' was limited to such persons who would be in possession of information because of their immediate relationship with a company or with the directors of a company.

Yet, even with respect to the so-called classical company insiders, s 233 seemed to be defective because it did not even ensnare all such persons: a person other than defined in this provision who obtained information by virtue of a relationship of trust or another contractual relationship would not have fallen within the s 233 net.[853]

The former definition of the insider was completely revised when the 1973 Companies Act was amended. The broadened concept was already to be found in the amendment of the Act in 1989, which applied to 'any director, past director or officer of a company or any person connected with the company having knowledge of any information likely ...'[854]. This wording was similar to that of the original provision of the 1973 Act. Yet, the 1989 amendment then went on to extend the insider trading prohibition to 'any other person, having directly or indirectly received from *any*[855] person mentioned in paragraph (a) (ie the persons enlisted above) such information, ...'[856]. It is therefore clear that the decisive step to extend the scope of the provisions on insider trading occurred in the 1989 amendment. Since then insider trading, for instance, by tipees[857] has been encompassed.

A problem in the application of the 1989 amendment (if it had come into

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853 Jooste op cit (1990 SALJ) at 596.

854 Sec. 440A(2)(a) of the 1989 Act.

855 My emphasis.

856 Sec. 440A(2)(b) of the 1989 Act.

857 The expression 'tippee' is certainly not an elegant one. It was removed (after having been used in the Criminal Justice Bill 1993) when first presented to the House of Lords because the word drew strong opposition from their Lordship as being 'a monstrosity, a perfectly awful word, ambiguous slang' (see Parliamentary Debates, HL, 19 Nov 1992, cols 756-767).

It has been adopted not only in the literature, but also by the Supreme Court of the United States in Chiarella v US 445 US 222 (1980). Therefore, despite its deficiencies and inconveniences, it is used because it depicts well what happens, ie someone who is not a source insider but receiving information; this is also the prevailing view in the English literature, see, for instance, Tridimas, 'The House of Lords rules on insider trading', (1989) 59 Modern Law Review 851 at 855.

force) would have been that those 'other persons' would have fallen within the legislation only if they had 'directly or indirectly *received*'[858] the information from a company insider.[859] One could have argued that certain ways of acquiring information might not have been covered by the word 'received', namely the possession of information through theft or espionage.

However, this gap has been filled by the present legislation. Section 440F of the 1990 Act now refers to 'any' person who deals in a security on the basis of material non-public information. Thus so-called primary insiders are within the definition as well as the so-called secondary insider.

II. Analysing the insider as defined in the 1990 Act

The 1990 Act does not include categories of insiders. Instead, it describes methods of acquiring information. It refers to '*any* person who ... deals in a security on the basis of unpublished price-sensitive information ..., shall be guilty of an offence if such person knows that such information has been obtained ...'[860]. What follows then is the description of these ways of acquiring the information. Thus, theoretically, anybody can, under circumstances analysed hereinafter, commit the offence of insider trading. This approach is textually fairly broad, and differs markedly from the approach chosen by the Directive. This is quite interesting, because the Directive is generally considered to be quite widely encompassing.

1. How to 'obtain' information to be within the definition

'Any' person is prohibited from dealing in securities if 'such person' knows that such information has been obtained

(a) by virtue of a relationship of trust or any other contractual relationship, whether or not the person concerned is a party to that relationship; or

(b) through espionage, theft, bribery, fraud, misrepresentation, or any other wrongful method, irrespective of the nature thereof.[861]

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858 My emphasis.

859 Sec. 440A(2)(b) of the 1989 Act.

860 Sec. 440F(1).

861 Sec. 440F(1)(a), (b).

It is apparent that the new definition is based on a fairly broad conception of an insider. A wide range of relationships is covered, from at the one extreme a relationship of 'trust' to 'fraud' at the other. This may indicate that the source of the information is no longer of great importance. Instead, what is important is that the information is used in securities markets.

The word 'obtained' is to a certain extent ambiguous: it may mean procured or gained as a result of purpose and effort, or it may simply mean 'acquired' or 'got'.[862] Given the purpose of the law it is submitted in Henochsberg[863] that the second or wider meaning should be applied. This view is supported by an English decision rendered by the House of Lords,[864] in which it was held that the insider 'obtained' information if he acquired or got it without any effort on his part. Let us now consider these methods of obtaining information in more detail.

a) Relationship of trust or contractual relationship

A 'relationship of trust' is the first category of the definition. It includes a fiduciary relationship, such as between a company and its directors, senior executives, financial advisers, or attorneys.[865] For the purposes of this provision, it is, clearly, immaterial how the relationship of trust arises or what the nature or terms of the contract may be.[866] In the literature, it is assumed,[867] that the legislature here intends to focus on the fiduciary relationship between a director of a company and the company itself. This is misleading insofar as it could be thought to maintain the approach of 'primary' and 'secondary' insider trading. This distinction, however, is not generally relevant under the new provisions.

Jooste[868] thinks that relationships falling short of fiduciary constraints but

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862 See Henochsberg op cit (Companies Act) at 977.

863 In Henochsberg, idem at 977.

864 See R v Fisher [1988] 4 BCC 360, on appeal sub nom Attorney General's Reference (No 1 of 1988), [1989] 2 All ER 1, affirming the decision of the Court of Appeal [1989] 1 All ER 321, [1989] 2 WLR 195; for a comment on the decision see Tridimas op cit (1989 Modern Law Review) at 851.

865 Jooste op cit (1990 SALJ) at 596.

866 Henochsberg op cit at 978.

867 Henochsberg, idem at 978.

868 Op cit at 596.

in which there is an expectation of confidentiality between the parties, would also be included in this category. This view is certainly correct. Unlike the formulation in the old s 233, the new formulation encompasses relationships other than those of trust, eg mere contractual relationships. A consultant or a professor who is contractually bound to give expert opinion would therefore seem to fall within this category.

The 'insider'[869] dealer need not be a party to that relationship. The person who actually deals can be an outsider not only to the company, but also to the contractual relationship. The law does not require that the information be passed voluntarily to a tipee. It may also be passed on inadvertently because the state of mind of the person, from whom the inside information is received, is irrelevant.[870] Indeed it would seem that the law does not even require that the information be passed on. It is sufficient that the person who deals on the strength of it knows where it stems from. Thus a tipee can also obtain the information by mere coincidence. Jooste[871] furnishes the example of a third party who overhears the conversation of two directors about an imminent take-over. The third party´s dealing falls within the ambit of s 440F despite the fact that the directors may be totally unaware of his presence.

The only requirement is that the person who deals knows that such information 'has (originally[872]) been obtained by virtue of such a relationship. Thus, the so-called tipee falls within this alternative of the provision in cases where the insider 'by virtue of a relationship of trust' passes on the information to the tipee. But it must be proved in each case that the tipee was actually aware of the pre-existing relationship of trust. This may be difficult when the source of the information is not obvious.

The same applies in the case of a tipee who obtains the tip through another tipee.[873] The more remote from the source of information the tipee is situated, the more difficult will it be to establish that the tipee knew about the relationship of trust. It is not obvious why the South African legislation

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869 Sec. 440F(1)(a) speaks of the 'person concerned'.

870 Jooste op cit at 596 et seq.; Henochsberg op cit at 977.

871 Op cit at 597.

872 My addition.

873 Jooste op cit at 596 suggests that the chain between the tipees can, theoretically, go on ad infinitum.

introduced this requirement, since it poses problems for the prosecution. Why had this old element (ie relationship of trust, or connection to the company) of the former law to be maintained? This is all the more surprising because the legislation was based on the hypothesis that insider trading could harm other market participants[874]; and the new approach clearly protects fiduciary relationships more than securities markets.

b) Espionage, theft, and misrepresentation

'Any person', who knows that access to the inside information was gained 'through theft, espionage, bribery, fraud, misrepresentation or any other wrongful method, irrespective of the nature thereof'[875], is prohibited from dealing on this information. It would seem that this provision is broad enough to encompass practically all methods of obtaining the information illegally. Other 'wrongful methods' could be violence, threat, or duress.

This shows that the prohibition is not limited to primary or to secondary insiders. A person, who gains inside information by virtue of a relationship of trust with one company, can, at another time - obtain information about another company through bribery - while remaining an outsider to that other company. It is apparent that the terms 'insider' and 'outsider' do no longer have much significance.

2. Primary insiders and secondary insiders - and some remarks on the use of these terms

The law does not speak of 'primary' or 'secondary' insiders. Nevertheless, these terms are quite often used in juristic literature.[876] They were originally designed to distinguish the classical company insiders from other people who obtain inside information only when an insider passes it on to them. The approach underlying such a distinction was a rather restricted one; it existed in conjunction with certain provisions requiring the keeping of registers as the only means of protection against insider dealing.

As we have seen, this distinction is no longer necessary under the South

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874 Which is in fact very difficult to support, see for a closer consideration of this problem Wang op cit ('Who is harmed') at 1217.

875 Sec. 440F(1)(b).

876 See, for intance, Jooste op cit at 596.

African law. When we discuss the European insider definition, we shall see that the concept of 'primary' insider trading may also vary between different laws because the new conceptual approach no longer exclusively applies to 'classical' insiders. The mere use of the term would therefore evoke ambiguity. The legislator has done well not use those terms.

3. Yet, some are not caught ...

Before evaluating the South African insider concept, it is useful to examine the cases in which a person dealing on non-public information is not regarded as an insider, and does therefore not commit an offence.

In the context of s 440F(1)(b), 'misrepresentation' must certainly be construed ejusdem generis with the words 'espionage' and 'theft'[877] because both these words are also used in the same provision. The intention of the law is to encompass *fraudulent* misrepresentation. The law indicates by the words 'other wrongful' that it refers exclusively to wrongful conduct. Thus, dealing on inside information obtained through innocent or negligent misrepresentation is not covered by the provision.[878]

The only offence in terms of the law is insider 'dealing'. Neither counselling nor procuring of information have been outlawed.[879] This is different from the European approach. Thus a director who passes on the information to an outsider is not guilty of an offence (he could at best be held liable for aiding and abetting), even if he knows that the 'outsider' will deal on the basis of that same information.[880]

This would be different only if the 'outsider' dealt on behalf of, or for the benefit of, the director. In the latter case the director would deal 'indirectly'[881] which is also prohibited by the law.[882] It would seem that no other (eg indirect) advantage which is given to the director for the passing on of the information is included in 'dealing indirectly'. The fact that a director, who gives a 'tip' based on inside information, would not be caught

877 Henochsberg op cit at 978.

878 Henochsberg, idem at 978.

879 Jooste op cit at 597.

880 Jooste, idem at 596.

881 Sec. 440F(1).

882 Jooste op cit at 596.

as an insider in terms of s 440F, seems rather surprising and will be dealt with in more detail below (see the chapter on 'offences').

III. Evaluation of the definition of the insider in South Africa - what is the underlying concept?

1. On the purpose of this evaluation

The evaluation of the insider definition clarifies two things: firstly, the concept which underlies the provisions on insider dealing in general, and, secondly, how far the definition of the insider is in line with this concept. The evaluation process will thus reveal the extent to which the intentions of the legislator have been transformed into the actual law.

The evaluation also illuminates the policy which underlies the legislation as a whole, namely that of the protection of the individual investor. For this to become obvious, the definition of the insider must be examined together with the definition of inside information. We have seen that the definition of what constitutes inside information is very vague, with the consequence that professional investors run a high risk of criminalisation. This might protect investors in that insiders are deterred, but it is certainly not beneficial for the capital market, because its liquidity is reduced.

2. Textual criticism

The intention is to cast the penal net widely.[883] Hence one expects the definition of the insider to be very far-reaching. And this is indeed the case. The provision encompasses 'any person' regardless of his profession or his relationship with an issuer of securities. In this respect, the definition is sufficiently broad to cover all situations where an investor has an informational advantage over the other party. The provision is in line with the intention to afford maximum investor protection which is also reflected in the creation of a civil remedy in a subsection of s 440F(4).

The technique used by the legislature is interesting. Instead of providing a list of primary and secondary insiders, the mere possession of inside information is now sufficient. The law does not even specify the methods by

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883 See Henochsberg op cit at 976 et seq.

which the person who deals must have obtained the information. This approach is good because it focuses on the essential element of insider trading prohibitions, namely, the trading on non-public information.

This approach is in line with the devices applied by market authorities to detect insider trading. On impersonal markets, these devices necessarily work without taking into consideration the personality of the trader. In other words, for detection devices, any trader could be an insider trader. The approach chosen by the South African legislature also corresponds to the economics of the theory of detection. It would seem, therefore, that as far as investor protection is concerned, the insider definition converts the intentions of the legislator into the text of the law. But it remains a shortcoming that no prohibition is imposed on the insider who passes on the information to another person.[884]

The prohibition does, however, contain an inappropriate qualification: the person who finally deals on the strength of the information must know that it was obtained either through a fiduciary relationship or through a wrongful method. This element indirectly maintains the distinction between primary and secondary insiders. It is submitted that the law has to a certain extent blurred the benefits of the investor protection approach by moulding it into concepts that relate, historically, to an extended version of the former company insider approach. This element brings about textual and, above all, conceptual inconsistency.

The defence will of course try to raise the following two arguments: firstly, that the alleged insider was not in possession of the information at the time that the trade occurred; secondly, and (what will be particularly difficult to prove) that the decision to buy or to sell was not based[885] on the information, although the insider had knowledge of it. And, on top of all this, the prosecution must establish that the insider knew where the information originated from. This is unnecessarily complicated.

It is submitted that the law also requires that the particular inside knowledge the insider has must result[886] in his subjective decision to trade.

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884 Jooste op cit at 596.

885 Sec. 440F(1) says 'on the basis of ...'.

886 The argument of the prosecution will be based upon the fact that the trade occurred shortly before the publication of the news or, that the volume of the trade was

In the case of a professional dealer this can turn out to be very difficult to establish because professionals gather a great deal of relevant public data which may ultimately have caused their trade decision. They will try to raise the defence that some other piece of information made them decide to deal. This requirement further complicates effective prosecution.

3. Conceptual criticism

The formulation 'any person' is sufficiently broad to lend itself to the conceptual basis of individual protection. Whether investor protection is really an issue in modern insider trading still needs to be discussed. The Directive, for instance, intends much more to protect the functioning of the markets. At this stage of the examination, however, the question is whether the South African legislature has succeeded in moulding the text to reflect its own policy of investor protection.

A classic[887] counter-argument against the proponents of insider trading is to say that allowing it does not result in the recompense for (insider-) entrepreneurs which the proponents wish. Since many insiders do not have enough capital to exploit the information, the profits that should reward them for their entrepreneurial work are redistributed to other people. The only way for insiders to profit would then be to sell the information to outsiders who can exploit the information. In terms of 'investor protection', however, it is then a major shortcoming of the South African insider provisions that such imparting of inside knowledge is not banned.

What is more, there is an apparent lack of coherence in the policy underlying the South African insider definition. If its purpose is investor protection, the source of the information should really be irrelevant, as long as it can be established that the trader was in possession of inside information. The fact that the insider knew where the information originated from does not strengthen the policy of investor protection. For the protection of the markets (and thus also for the investors) it is of importance only that the dealer had inside information. But this requirement is already contained in the word 'knowingly'[888] in

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exceptionally high either with regard to the average trade volumes of the affected share, or with regard to the average trade volumes of the alleged insider dealer.

887 See, for instance, Schotland op cit ('Unsafe at any price').

888 For the necessity of men´s rea as indicated by the word 'knowingly' see below in the

s 440F(1),[889] and did not need to be added again to the insider definition.

Emphasis on investor protection aside, it is conceivable that insider rules are developed with the declared aim of protecting business rights. The 'property rights' approach, although often leading to a result in favour of insider dealing (see Manne´s now seminal work in 1966[890]: non-public information is a corporate asset). In terms of the 'property rights' approach (not, however, in Manne´s) the wrong committed is that of theft or conversion because the information belongs to the firm.[891] Here the question of where and how the trader acquired his knowledge (an aspect less central to the 'fairness' approach) becomes important.

In the tipping situation, the 'tipee' is in the position of a person receiving stolen property.[892] Only if the policy underlying the South African insider prohibition were indeed the protection of business rights, would there be a good reason to require that the insider dealer had knowledge of 'how the information was acquired'.

If the main purpose of the law had been to protect the company against breaches of fiduciary relationships, it would have been necessary to extend the ban to include the act of imparting such knowledge. Yet, as we can conclude from the complete absence of a corporate remedy, the aim of the ban was certainly not that of business protection.[893]. The only remedy created is in favour of the other party to the insider transaction.

Since the South African legislature sought to place investors on an equal footing and to enhance investor protection, the element 'knows that such information has been obtained' is inappropriate, and will put an unnecessarily high burden on the prosecution.

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chapter 'offences and defences'.

889 See Jooste op cit at 592.

890 Op cit (Stock Market); his position was dealt with in Part I of this study.

891 Scott op cit (Journal of Legal Studies) at 814.

892 For a fine description of this concept see Scott op cit at 814, who also endeavours to apply this concept to the Texas Gulf Sulphur case 401 F 2d 833 (2d Cir 1968) and to United States v Chiarella 588 F 2d 1358 (2d Cir 1978), rev´d, 100 S Ct 1108 (1980); for an interpretation of the Chiarella case in the light of different approaches see also Macey op cit ('From fairness to contract') at 207 et seq.

893 See, for instance, s 16(b) of the US American SEA 1934; for a detailed analysis of this provision see Carlton and Fischel op cit at 891 et seq.

It is submitted that the insider definition is an unbalanced mixture of three theories applied to insider cases in the USA: the 'equal access' theory; the 'fiduciary' theory; and the 'misappropriation' theory[894]. As under the repealed sections, the South African definition of 'inside information' makes it very difficult to prove a contravention. Essentially, the definition of the insider remains conceptually vague and incoherent, which will probably result in various difficulties for the prosecution. Hence, it is doubtful whether the law brings about the intended deterrent effect.

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894 Dealt with in Part I of this study; see Kraakman, 'The legal theory of insider trading regulation in the United States', in Hopt/Wymeersch (eds) op cit (European insider dealing) at 39; see also Scott op cit at 801-818.

B. The 'insider' as defined by the European Directive

It is useful to consider the policy of the Directive before entering into a detailed analysis of the English and the German insider laws. Two different patterns emerge from the insider-definitions which were applicable in the Member States before the European Directive came into force. According to the first pattern the 'insider' was defined by means of a list which was sometimes supplemented by a more general clause. The second pattern sought to define the insider by reference to more general criteria, eg 'directors and employees of a comany', or 'persons in possession of price-sensitive information'. The Directive attempts to reconcile these two patterns, and that resulted in a very comprehensive definition.[895]

I. The wording of the Directive

The definition of the 'insider' is contained in articles 4 and 2 para 1. The Directive stipulates in Art 4, that

> 'Each member state shall also impose the prohibition provided for in article 2 on any person other than those referred to in that article who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than a person referred to in article 2.'

It is obvious that Art 4 refers to the so-called tipees (ie persons who receive information as opposed to generating it). Their trading is called secondary insider trading. Thus, the so-called 'secondary' insider trading is also caught by the European definition. The central provision, however, is contained in Art 2 para 1 of the Directive which reads:

> Each member state shall prohibit any person who:
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> - by virtue of his membership of the administrative, management or supervisory bodies of the issuer,
> - by virtue of his holding in the capital of the issuer, or
> - because he has access to such information by virtue of the exercise of his employment, profession or duties,
>
> possesses inside information, from taking advantage of that information with full knowledge of the facts by acquiring or disposing

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895 See Tridimas op cit at 924.

of, for his own account or for the account of a third party, either directly of indirectly, transferable securities of the issuer or issuers to which that information relates.

The Directive does not use the terms 'primary' or 'secondary' insiders. Given the scope of the provisions relating to 'tipees', it may appear pointless to spend much time and effort seeking to determine whether a person is a primary insider.[896] However, the Directive does not impose the same restrictions on all insiders. Therefore, one has to make the distinction.

Surprisingly, so-called secondary insiders are prohibited only from dealing on the basis of inside information,[897] not, however, from counselling. Given the aim of the Directive to protect the markets, and taking into account the economic finding that all kinds of insider trading (ie including transactions by secondarily informed traders) have the same effect upon the markets, one would have expected that such trading is also prohibited.

II. Groups of insiders and conceptual approaches

Under Art 2 para 1, there are three categories of persons both legal and natural who are not permitted to trade when in possession of inside information.[898] Art 2 para 2 makes it clear that 'where the person referred to in paragraph 1 is a company or other type of legal person, the prohibition ... shall apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.' The Directive here sticks to the principle 'societas delinquere non potest'. It does not go so far as to make members of the management responsible for contraventions of the law committed by their employees as is the case in the United States.[899] The definition is also sufficiently broad to

896 Gore-Browne op cit at 12.039.

897 Art 6 of the Directive provides that the Member States 'may extend the scope of the prohibition ... and impose on persons referred to in Art 4 (ie other persons who possess inside information) the prohibitions laid down in Art 3 (ie disclose information, recommend, or procur a third party, on the basis of that information).'

898 See Ashe op cit (The Directive on insider dealing) at 17.

899 See Linklater and McElyea, 'Die Auswirkung von 'Corporate Compliance Codes' auf die strafrechtliche Haftung eines Unternehmens unter den US-amerikanischen 'Federal Sentencing Guidelines' ', RIW 1994 at 117.

encompass market insiders.

Of the aformentioned categories of insiders, the third (ie 'insider by virtue of employment, profession, or duties) is the broadest, encompassing as 'primary' insiders all those who have access to inside information by virtue of their professional status.[900] This encompasses the employees of the company itself, but also other persons such as bankers, auditors, lawyers and those who, though not a part of the company, are close to it.[901]

Tridimas[902] suggests that the test as to whether someone falls within this category is completely subjective, depending on a person's access to information and, whether he gains access by virtue of his position. The subjectivity is mainly on the side of the company that decides whether an employee has professional access to certain types of information or not. Vice versa, whenever information is sensitive, the management is deemed to know which employees have access to it. And only that makes the insider status of a person become an objective fact.

Tridimas[903] also thinks that in some respects the approach of the Directive is close to the US misappropriation theory[904]. But this is highly questionable. The preamble to the Directive points out the central role of the functioning of securities markets. The misappropriation theory, on the other hand, protects information as a 'property right'. The wrongful act of the insider may be the 'deceitful exploitation of information belonging to a third person',[905] whereas the wrongful act committed by the insider in terms of the Directive is to deal on a securities market. The Directive is concerned not so much with the relationship between the insider and the company, but with the potential relation between the insider and the other traders in the market.[906] The underlying concept of the Directive is

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900 Ashe op cit at 17.

901 Ashe, idem at 17.

902 Op cit at 924.

903 Op cit at 924

904 See Aldave, 'Misappropriation: A general theory', (1984) 13 Hofstra Law Review 101; in Part I of this study this approach was discarded.

905 Aldave, idem at 121; see also Chief J Burger dissenting in the Chiarella case 445 US 222 at 241.

906 See Davies op cit (Directive on insider trading) at 102 et seq.; Tridimas op cit at 926.

therefore not the misappropriation theory.[907]

The question is whether the Directive requires at least some kind of substantial connection between the insider's profession (or employment) and the company.[908] In this regard it is important to note that the Directive extends the insider-definition to tipees. It is not required for a tip to have been obtained in the exercise of his profession or the carrying out of duties.[909] The only relevant requirement is that the tipee uses inside data 'with full knowledge of the facts'[910]. By this formulation the Directive focuses on the tipee (if he trades) rather than on the source of the information.[911] It is submitted that the wording '... inside information, the direct or indirect source of which could not be other than a person referred to in article 2'[912] indicates that not only situations where information is explicitly passed on, but also situations where information is obtained through theft (or another wrongful method), are included in the Directive. Hence a connection between company and insider trader is not required.

III. Some remarks on the value of this definition

The Directive seeks to broaden the scope of persons that fall within the ambit of the definition. Art 4 demonstrates that the underlying policy is to pin liability on tipees who have the information itself, not on those who receive a tip based on the information.[913] The intention of the European law is thus to protect securities markets, not, however, property rights or fiduciary relationships between insider and company.

Bearing this in mind the Directive should rather not have provided insider categories. It seems that the definition is still (partly) based on the outdated concept of the 'company insider'. It has to be noted, too, that the old concept has not been replaced by a new one. And neither the 'protection of

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907 Hopt op cit (ZGR 1991) at 20 et seq.

908 See Davies op cit at 97; see Tridimas op cit at 926 et seq.; both authors support the interpretation which requires a link between insider and issuer.

909 Tridimas op cit at 928.

910 Art 4 of the Directive.

911 Ashe op cit at 18.

912 Art 4 of the Directive.

913 See Ashe, idem at 18.

the market' nor the 'protection of outsiders' are particularly helpful when defining the insider on the basis of that old company insider approach. What, for instance, is the possible damage to the market, if someone trades 100 shares, be he an insider or not? One would have expected a definition which takes into account that the possession of information is more important for the capital markets than the question of where the information originates from. In this respect the actual wording of the Directive is not consistent with the intentions laid out in the preamble.

It is submitted that the Directive leaves the Member States to do a large amount of legislative work, for instance, to extend the prohibition to counselling and procuring the information. In order to harmonise the provisions in the Member States, it would have been better to mould more clearcut definitions which also reflect the intentions of the law.

C. 'Insiders' under the English Law

It is interesting to examine now whether the English law has maintained its own approach to insider trading. We shall see that there are certain deviations from the European law.

I. Overview of the definition

We shall begin with a brief overview of the new English definition of the insider, which has brought about some changes in terminology and - due to the European influence - some 'new groups' of insiders.

1. Terminology

Part V of the Criminal Justice Act 1993 (CJA) does not use the terms 'primary' and 'secondary' insider (nor the term 'tipee'). Given that these terms are widely used in practice and literature, some commentators think, however, that they will also be used by the courts.[914]

2. Groups of insiders

The CJA uses the concept of having information 'from an inside source' and then defines 'inside source' exhaustively[915] as having information either

(i) by virtue of status[916] or,

(ii) if the direct or indirect source of his information is a person within para (i).[917]

Thus, there are two categories of 'insider':

(a) 'primary' insiders who have access to the information by virtue of their status[918] and

(b) 'secondary' insiders or 'tipees' who got the information from

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914 See Lomnicka op cit ('The new insider dealing provisions') at 179.

915 The exact formulation is: '... if and only if', so as to emphasise the exclusive charakter of this element, cf s 57(2) of the CJA 1993.

916 Sec. 57(2)(a)(i) and (ii).

917 Sec. 57(2)(b); see Lomnicka op cit at 179.

918 Sec. 57(2)(a); see Lomnicka op cit at 179.

a primary insider.[919]

The first group of insiders (ie the so-called primary insiders) consists of persons who have information through

(i) either 'being connected'[920] with the issuer[921] of securities as director, employee or shareholder of the issuer[922]
or
(ii) having access to the information 'by virtue of ... employment, office or profession.'[923]

The second group (ie the so-called secondary insiders) consists of persons whose 'direct or indirect source of ... information' is a person of the first group.[924] Thus, anyone who has information emanating from a primary insider, no matter how long the chain[925] of communication is, may be referred to as a secondary insider.

In order to commit the insider-offence (ie dealing, encouraging to deal, or disclosing the information), the person who deals, encourages, or discloses must have 'information as an insider'.[926] This is the case where he has the information from an inside source, either through his position or through a person who occupies such a position.[927] The statute makes it clear that both an objective and a subjective element must be fulfilled.[928] The individual is

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919 Sec. 57(2)(b); see Lomnicka op cit at 179.

920 Nota bene that the term 'connected' does not mean that there has to be a link of confidentiality between the person and the issuer of the shares.

921 Defined in s 60(2) as 'any company, public sector body or individual by which or by whom the securities have been or are to be issued.'

922 Sec. 57(2)(a)(i).

923 Sec. 57(2)(a)(ii).

924 Sec. 57(2)(b); see Lomnicka op cit at 179.

925 Lomnicka op cit at 179 fn 76, who correctly remarks that problems of proof will become more difficult, the longer the chain is.

926 Sec. 52(1) ie dealing; s 52(2) ie encouraging and disclosing; Lomnicka at 180.

927 Sec. 57(2); see Hannigan op cit (1994 Insider dealing) at 77 et seq.

928 Sec. 57(2) provides that a person has information from an inside source '*if and only if*' (my emphasis) he has it (ie the information) through ...'. This again reveals the extent to which the new law is still under the influence of the old patterns, eg the insider being 'inside' something rather than simply being a person who deals

an insider *if and only if* he has information and knows that it stems from an inside source.[929]

Put another way, in order for an individual to have 'information as an insider' he must be an 'insider' in the sense of having access to inside information either as primary or secondary insider, *and* he *must know* both that the information is 'inside' and that he is an insider.[930]

II. Changes to the old law

Probably the most significant change in the law is the abandonment of the traditional requirement in English legal thinking, namely, that the insider should in some way be 'connected' with the company in whose securities he makes his illicit profit.[931]

The previous law in England imposed liability for 'primary insider dealing' on three categories of insiders. All three of them had to have either a legal or at least a moral duty of confidentiality towards the company.[932] Under s 9 of the Company Securities Act 1985 an insider was a person *connected* with a company; this encompassed (a) directors; (b) officers and employees; and (c) those in a professional or business relationship with the company.[933] The scope of that definition was limited by the requirement that an insider had to occupy a position which may reasonably be expected to give him access to unpublished price-sensitive information.[934] Thus an office-cleaner taking the opportunity to rummage through waste-paper bins or desks was not considered a primary insider, since his access to information gleaned in this enterprising manner was in breach of his duties rather than in their performance.[935]

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on the strength of inside information. Only the latter would befit the European market approach.

929 Halsbury's Laws of England, Cumulative Supplement 1994, paras 1060-1066, vol 7(1) (reissue) at 61.

930 Lomnicka op cit at 180.

931 Gore-Browne op cit at 12.035.

932 Gore-Browne, idem at 12.036.

933 Hannigan op cit at 78.

934 Hannigan, idem at 78.

935 Gore-Browne op cit at 12.036; Wotherspoon op cit at 425.

Because the confidentiality requirement has now been dispensed with,[936] the new Act seems to impose considerably wider potential liability than the former legislation.[937] For instance, it seems that the office cleaner will now be caught. The new law (in accordance with the Directive) does not, however, confer an 'automatic insider status' on any category of persons.[938]

Art 2 of the Directive stipulates that a person shall be prohibited from taking advantage of information which he possesses 'by virtue of ...'. This is transposed into the English domestic law in s 57(1)(b) of the CJA which requires that the person has information 'if and only if he has it ... from an inside source'. It is obvious that information which is obtained by a manager from an external source would not make him an insider in this category, because he does not obtain it 'by virtue' of his position. Another result of the abandonment of the 'connection'-requirement there is no longer a time-limit[939] beyond which a person ceases to be 'connected'.[940]

Shareholders were previously not included as insiders under the Company Securities Act 1985 (CSA), although clause 63 of the Companies Bill 1978[941] would have included substantial shareholders, defined as 'holding in excess of 5 % of the share capital'. The position under the CSA was that, if shareholders were to be caught, it was as tipees.[942]

The Company Securities Act 1985 required that the tipee 'obtained', directly or indirectly, unpublished price-sensitive information from a primary insider. It was an issue under the old law whether 'obtained' had the connotation of having the information 'as a result of one´s effort'.[943] That issue is 'dead' and no longer relevant with the dropping of the concept of 'obtained'. It does no longer matter whether the tipee is a passive

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936 Davies op cit at 98.

937 Gore-Browne op cit at 12.037.

938 This view is expressed by Wotherspoon op cit at 425.

939 Under the old Act this limit was laid down in s 1(1) of the CSA which required the individual to have been knowingly connected with a company at any time in the preceding 6 months.

940 Lomnicka op cit at 179, fn 69.

941 See Pigott, 'The companies Bill 1978 and company law reform', in: Rider (ed), 'Regulation of the British securities industry' at 104.

942 Hannigan op cit at 80.

943 See Hannigan, idem at 87.

recipient or has actively procured the information.[944]

III. Who exactly is an insider?

Let us first examine the 'classical' insider in order to clarify the extension of insider concepts that have been brought about by the Directive and its transposition into the new English provisions .

1. Directors and shadow directors

If a person possesses inside information (as defined in s 56 of the Criminal Justice Act 1993 Part V) and knows that he has it 'through being a director', he is an 'insider' according to s 57(1), (2)(a)(i) of the new Act.

Directors form the most straightforward and most easily identified category of insiders.[945] All directors, executive and non-executive, are included in this part of the definition.[946]

Shadow directors are not specifically included, although the Department of Trade and Industry had proposed their inclusion.[947] A shadow director is defined as a person in accordance with whose directions or instructions the directors of the company are accustomed to act.[948] The shadow director is expressly included in many other areas of company legislation.[949] Since the legislature left them out where insider trading is concerned, this omission can be assumed to be a deliberate one. Shadow directors can therefore not be subsumed under the term 'director'.[950]

Hannigan[951] rightly adds that a limitation is to be noted here, namely, that the person must have the information through being a director. In the (unlikely) event that he can show that he has the information as a result of

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944 Hannigan, idem at 87.

945 Hannigan, idem at 78.

946 Hannigan, idem at 78.

947 Law on Insider Dealing, a Consultative Document (Dec 1989, DTI), para 2.25.

948 Sec. 741(2) of the Companies Act (CA) 1985.

949 For instance ss 309, 319, 320, 321, 322, 330-346 of the CA 1985; cf Lomnicka op cit at 179 fn 71.

950 Hannigan op cit at 78; Lomnicka op cit at fn 71.

951 Idem, at 79.

some other position or connection, he is not caught by this provision although he may have fallen foul of the tipee provision. The burden of proof is on the prosecution to show that the person was indeed in possession of the relevant information.[952]

2. Having the information 'through being' an employee of an issuer of securities

A person is also considered having information from an inside source, if he has it through being '... an employee of an issuer'.[953] The issue here is whether an employee must have access to the information in order to fall within the ambit of this provision, and if so, what type of access.

Under the Company Securities Act 1985, a person, in order to be caught as an insider, had to occupy a position which could reasonably have been expected to give access to information'.[954] Some English commentators[955] suggest that a person, in order to fall within the new definition, must have 'access' to the information by virtue of that employment. Thus, it may seem reasonable to assume that information *created* or *stolen* by an employee

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952 Under the old CSA 1985 this was clearly expressed in the case John Morris Cross by McCowan LJ, (1990) 91 Cr App R 115, at 120: 'The prosecution plainly have to prove all the matters in section 1(1)'. For an overview of the former legislation see Poser op cit (International securities regulation) at 163 et seq.; see also Halsbury's Laws of England Vol 7(1), London, 1988 paras 1060-1069; for a comprehensive history of insider trading legislation see Naylor op cit (The use of criminal sanctions I) at 55 et seq.; for a South African comparative analysis see Botha, 'Control of insider trading in South Africa: A comparative analysis', (1991) 3 SA Merc LJ 1.

953 Sec. 57(2)(a)(i).

954 Sec. 9 CSA 1985; cf Hannigan op cit note 207 at 79.

955 Gore-Browne op cit at 12.037 et seq; Rider and Ashe op cit (Insider crime) at 41, who argue that a window cleaner could hardly be said to have gained access to inside information by virtue of his employment. It should be borne in mind, however, that if the cleaner is not an insider, then the person who receives the information from him will not be within the scope of the insider-definition, however important this second person is for the securities markets (example: a broker has bribed the window cleaner to look out for information). This again reveals that, although in terms of their 'Preambles and intentions' the new provisions seem to convey a new market approach, they in fact do not so.

would not be regarded as information to which that individual had access to by virtue of that employment.[956]

It is submitted that this interpretation is probably not correct. The element of access does no longer appear in the legislation. Employees are insiders, if they have the information through being an employee, even though they do not occupy a position of access.[957] The terminology 'having access' also applies to situations where no regular access is given to someone, but his employment opens up the possibility of obtaining the information outside his 'normal' duties, but through a wrongful act (eg the window cleaner breaks into the desk where sensitive information is kept) or coincidence. Take, for example, the case of a junior employee who happens to see documents containing information when he goes to the print room.[958]

In the preamble to the Directive recommendations are exempted only when they are based on public information. Hence other recommendations will fall within the scope of the insider trading prohibition, irrespective of how much of his *own* work the analyst, who works for a financial conglomerate, put into the production of the new information, eg that 'it is good to buy XY-shares now'. The fact that an employee *produced* valuable information does therefore not mean that he cannot be an insider, at least so long as he is working for a company. Also, the information belongs, in practically all cases, to the employer. In the chemical industry, for instance, working contracts will normally contain a clause which says that inventions made by the employee during his employment belong the employer.

A comparison with the text of the new German law makes it clear what the formulation would look like if the 'access to information' is intended exclusively to comprise 'regular' access through one´s work. § 13(1)(No 3) WpHG reads:

> (1) An insider is any person who ...
>
> > 3. by reason of his profession, business or function *and when executing his appointed* [959] activities ...

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956 Gore-Browne op cit at 12.037.

957 Hannigan op cit at 79.

958 Hannigan, idem at 79.

959 My emphasis.

The result of such a formulation[960] is that all persons are excluded who gain access to sensitive information through a wrongful act or by coincidence while being an employee. If the English legislature had wanted to achieve this outcome, it would have certainly added a similar wording. From the fact that it did not, we can conclude that it wanted those cases to fall within the ambit of the prohibition. This view is supported by the English deviation from the Directive according to which (at least in the English[961] version) only the employee who

> 'because he has access to such information by virtue of the exercise of his employment, profession or duties'

shall be prohibited from taking advantage of that information.[962]

The present formulation of the English law makes sense, if one bears in mind that the approach preferred by the Directive is a wider one than that contained in the former English law. The Directive seeks to protect the integrity of the markets rather than to criminalise the abuse of a position or relationship with a company.[963]

On the other hand, the protection of relationships of trust or confidence within a company has not at all been mentioned as an aim of regulation. The English criminal law (unlike the interpretational limits under the German constitutional law) allows for an approach which is based on the objectives and not the letter of the Act,[964] thus also taking into consideration the

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960 It has to be noted at this juncture that the German formulation is not in line with the European Directive, and that it contains major shortcomings.

961 The German version of the Directive (ie 'aufgrund seiner Tätigkeit', although translated into English: 'by virtue of his employment'), on the other hand, is open to an interpretation which includes the situation where the employee's access to the information is not based on the execution of his functions; see Hopt, 'Zum neuen Wertpapierhandelsgesetz - Stellungsnahme für den Finanzausschuß des Deutschen Bundestages', in: WM-Festgabe für Thorwald Hellner zum 65. Geburtstag am 9 Mai 1994, 29 at 30; see also Claussen op cit (DB 1994) at 29 fn 19.

962 Cf Art 2(1) of the Directive.

963 Hannigan op cit at 81.

964 See dictum of Lord Reid in DPP v Otewell [1968] 3 All ER 153 at 157, [1970] AC 642 at 649.

intentions of Parliament.[965] It must, however, be borne in mind that the intentions of the European legislator (ie market protection) are more important for the analysis of the European Court than any national legislative debate or intention.

It is submitted that, when the courts decide that a person deals on the strength of inside information, but his possession of the information is not covered by the formulation 'having access', this person then falls within the alternative of 'having the information through being an employee'. This is reasonable because of the shortcomings of the alternative of 'having access'.

3. Shareholders

An insider is also someone who has inside information through being a shareholder.[966] Shareholders were not regarded as 'access-insiders' under the Company Securities Act 1985. Their omission from the legislation certainly raised some questions, in particular with regard to the position of institutional or controlling shareholders, who most certainly have informational advantages.[967] Shareholders have now been included without limitation in the sense that there has been no attempt to identify substantial shareholders or to set a threshold.[968] This is good law and fully in line with Art 2 of the Directive.

One might be lead to think that not all shareholders should be regarded as insiders.[969] In the US, for example, based on case-law, only controlling shareholders are regarded as insiders. This is because such persons are likely to have a similar degree of access to information as a director.[970]

But there is nothing curious about this inclusion, if one bears in mind, once again, that the Directive focuses our attention on the *abuse* of inside information, rather than on the abuse of specific positions. In every case, the prosecution must be establish that the person had the information

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965 See A-G's reference [1989] 2 All ER 1 at 5, by Lord Lowry.

966 Sec. 57(2)(a)(i).

967 Hannigan op cit at 80; Rider and Ashe op cit at 41.

968 Hannigan, idem at 80.

969 This is the view is expressed in the English literature, for instance, by Rider and Ashe op cit at 41.

970 Rider and Ashe op cit at 41.

through being a shareholder, and not in some other capacity,[971] a requirement which provides sufficient protection. A shareholder who has no inside information has nothing to fear by the breadth of the category, because he does still not fall within it.[972]

4. Having access to the information by virtue of his employment, office or profession

Persons are included as insiders who have inside information through having access to it 'by virtue of their employment, office or profession'.[973] This formulation extends the prohibition to people such as solicitors, auditors, lawyers, architects, surveyors, bankers, brokers, advertising and public relations agencies, consultants, management consultants, and investment advisors.[974] This again is good law, because the focus is on 'having inside information', not, however, on 'having a connection with an issuer of securities'.

The attractiveness of this category is that it should make it easier to prosecute people who obtain inside information through their work rather than directly from the company. The importance of this category is self-evident.[975] The above persons have easy access to inside information and often sufficient knowledge about securities markets to exploit the information.[976] The category seems open-ended, but there is an important limitation, namely, that the person must have inside information by virtue of his employment, office or profession.[977] This depends on how the courts interpret the requirement 'by virtue of their employment'.

On this issue the views expressed in the literature differ. Some think that the new provision, unlike that in the former law, casts the net considerably wider, so that people like the window cleaner who remove documents from

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971 Hannigan op cit at 80.

972 Hannigan op cit 80.

973 Sec. 57(2)(a)(ii).

974 Wotherspoon op cit at 425; cf also Hannigan op cit at 81.

975 Hannigan, idem at 81.

976 Hannigan, idem at 81.

977 For an extensive discussion of these alternatives in the European Directive see Tippach op cit (Insider-Handelsverbot) at 163 et seq.

someone´s desk now fall within the legislation.[978]

Rider and Ashe[979] and Gore-Browne[980] think it is unlikely that a court would hold that the information is obtained 'through having access', if it is generated by the employee himself. These commentators are of the opinion that in such situations the employee does not have *access* to the information which has an existence independent of himself. It would therefore be more accurate to say that the information is obtained 'through being an employee'[981]. If the employee were not in his position, eg working for the investment department of a bank, he would not have been able to generate the new information. From this we can conclude that a piece of information has an existence which is legally independent of the person who has generated it. In most cases this is so because the information (as an asset) belongs to the employer and not to the person who has produced it.

Let us assume that a financial journalist buys shares of a company ahead of the publication of his own favourable article on that company. If his view is based on inside information, his purchase would doubtlessly constitute insider trading. But even if it is based on publicly available data, it would be insider dealing because his own buying shortly before publication is not based on the public information, but rather on his expectation that the price of the share will rise as a consequence of his article being published. Indeed, often a price shift on the stock exchange is due to such a recommendation. The mere fact that such a recommendation is about to be published can therefore be regarded as price sensitive information and, consequently, dealing on the strength of this information is insider dealing. Incidentally, this is a good example of a market information. In any event, the fact that he generated the information does not exempt him from the insider trading prohibition.

Another problem may arise in situations where someone overhears a conversation whilst performing a professional duty. For instance, does the

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978 Gore-Browne op cit at 12.037; cf also Hannigan op cit at 81, who thinks that a court would be more likely to believe that the new wording is indicative of a new approach; but see, also in support of this interpretation, yet still based on the Directive, Hopt op cit (The European insider dealing Directive) at 51.

979 Op cit at 42.

980 Op cit at 12.037.

981 Sec. 57(2)(a)(i).

barman at the local golf club become an insider if he overhears inside information being discussed by a couple of senior executives as he takes their order?[982] The question is whether there must be a functional link between the person´s employment and the company to which the information relates. Tridimas[983] argues that there is a need for such a link because the final text of the Directive is opposed to both the Commission´s earlier proposal and the amended proposal.[984] Both proposals required that the information must have been obtained 'in the exercise of' the person´s duties. This would be a convincing if the text of a Directive were not valid in all official languages. The German text of the proposals, however, is:

> 'in Ausübung (ie 'in the exercise') seines Berufs ... Insider-Informationen erhält.'

This means that the person must obtain the information through a functional link with the employment. According to the final text, however, it is sufficient for the person to have 'Zugang' (engl.: 'access') to the information because of his employment. 'Zugang' comprises both regular access and coincidential knowledge, even obtaining the information through a wrongful act, so long as the possibility of misappropriating the information was in one way or the other opened up by the employment.

Thus, in sum, the barman is neither definitely within the legislation nor definitely excluded from the legislation. The ambiguity may very well eventually cause the European Court of Justice to be asked to give a preliminary ruling on this issue.[985]

If the prosecution shows that the barman 'knew' that the executives (whose conversation he overheard) were insiders, he would be regarded as having obtained the information from an inside source, and hence be liable as a tipee.[986] This approach is not very convincing, because the notion of a 'tipee' is that of a person being tipped rather than of someone overhearing a conversation. But could he be regarded as a primary insider? This is also

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982 This is an example furnished by Wotherspoon op cit at 426.

983 Op cit at 926 et seq.

984 COM (87) 111 fin, Art 2; COM (88) 549 fin, OF C 277/13 from 27 Oct 1988, Art 1(1).

985 Dine op cit at 62; see also Wotherspoon op cit at 426.

986 See Wotherspoon, idem at 426.

doubtful. Finally, it must be borne in mind that, if the barman is not an insider, a person who is tipped by him is also not liable under the tipee provision, because his information does not originate from an inside source - no matter how extensively he exploits the information or damages the functioning of the markets.

5. 'Other persons'

An important question is whether persons such as printers, financial advisors, journalists are within the scope of the new definition.[987]

a) Printers, editors, and distributors

Printers, editors, and distributors are clearly within the new legislation.[988] Under the former law there were allegations of insider dealings in drug company shares ahead of articles appearing in journals such as the British Medical Journal with regard to cancer treatment, or AIDS drugs.[989] Such matters would not necessarily have been considered insider dealing within

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987 The US jurisdiction in the Chiarella case, US v Chiarella (1980) 445 US 222, 63 L Ed 2d 348, 100 S Ct 1108, and in the Winans case, US v Winans 612 F Supp 827 (SDNY 1985), had to decide whether persons who bear such professional functions could be regarded as insiders. Winans was convicted of insider dealing, largely, it would seem, on the basis that he had taken confidential business information from the Wall Street Journal. The printer (Chiarella) who had dealt ahead of a take-over situation after he had (like Winans) 'by virtue of his job' obtained information regarding the target, was finally not convicted.

In these decisions the courts got bogged down in considerations whether these persons were duty-bound to disclose the information. It is submitted that there is no characteristic difference between the printer and the financial journalist which would sufficiently support the findings of the courts (the printer had, for instance, regular access to information about forthcoming take-over situations).

In an English case, a journalist was convicted. See Re an inquiry under the Company Securities (Insider Dealing) Act 1985 [1988] 1 All ER 203. The US-dilemma stems from rule 10 b-5 which was designed to combat fraudulent acts in face-to-face situations rather than dealings on stock exchange markets.

988 Hannigan op cit at 85.

989 See Hannigan, idem at 85.

the terms of the Company Securities Act 1985, because these persons were not 'connected' with the companies in whose shares they allegedly dealt; and they were not tipees either, since no source-insider was involved.[990]

b) Investment analysts and journalists

On principle, there should be no doubt that investment analysts, bankers, and other financial services people fall within the definition. It is probably with respect to investment analysts that there has been the greatest widening of the provisions, because they were not 'connected with companies' under the Company Securities Act 1985.[991]

As a group of potential insiders they can either be subsumed under 'the person who has information through being an employee' or 'by virtue of the exercise of his profession'. Gore-Browne[992] furnishes the example of a financial journalist who deals ahead of his own recommendation, and assumes that his recommendation is not inside information, because he has no 'access' to it, and the information has no existence independently of himself as a person. It is submitted that the journalist does indeed possess inside information 'through *being* an employee'. Otherwise a very obvious example of insider trading would not be caught; and, of course, this journalist would not know that a recommendation is about to be made (even though made by himself), if he didn't have his job.

c) Public servants

Many public servants and regulatory officials have, by virtue of their office, access to inside information. Under the Company Securities Act 1985 (CSA) it was necessary to identify each group as public servants by statutory instrument.[993] The new law does away with this by simply using the general category of 'those who have access to the information by virtue of their employment'.

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990 Hannigan, idem at 85.

991 Hannigan, idem at 84.

992 Op cit at 12.037 et seq.

993 Sec. 2 CSA 1985; see Hannigan op cit at 84.

So, for example, the new definition includes officers and employees of the Take-over Panel who were not public servants for the purposes of the former law.[994] This extension is good because, economically, it would not seem to make a real difference whether or not the insider is connected with a company. In this regard the English law is now very much in line with modern economic findings.

IV. 'Tipees' and sub-'tipees'

'Tipee' liability is the third category of insider liability created by the CJA 1993. A derivatively informed person must, in order to be liable, know that the information is 'inside'. He must also know that he has information from an 'inside source'.[995] A tipee has information from an inside source only if

> 'the direct or indirect source of his information is a person within paragraph (a)'[996], eg persons who have the information either 'through being a director ...' or 'by virtue of his employment ...'[997].

As mentioned above, the requirement that the tipee must have obtained the information either actively or passively has been removed. It suffices for the individual concerned to know that the source of the information was an insider. The liability of the tipee does not depend on the liability of the person who tips. For instance, it may occur that, in the course of negotiations, inside information is passsed on bona fide to a person.[998]

The problems of proof with respect to tipees become particularly acute, when one applies the prohibitions further down the line to sub-tipees. Certainly, the legislation, by referring to persons whose 'indirect' source is an insider, envisages the inclusion of the sub-tipee.[999] In practice it is very difficult to establish that the sub-tipee had information from an inside source and that he knew the information was from such source, particularly where information has passed through several hands and has, as a result,

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994 Hannigan, idem at 84 et seq.

995 Sec. 57(2) CJA 1993; cf also Rider and Ashe op cit (Insider crime) at 45.

996 Sec. 57(2)(b).

997 Sec. 57(2)(a).

998 Rider and Ashe op cit at 46.

999 Hannigan op cit at 88.

become diluted, perhaps exaggerated or changed.[1000]

Must the tipee (or even the sub-tipee) be aware of the identity of the inside source? Rider and Ashe[1001] think that it is rather unlikely that a court would hold that knowledge of identity was crucial.[1002] Nevertheless, it is uncertain whether the courts will decide that the (sub-) tipee must know the identity of the primary insider or the intermediate person or both[1003] in order to be caught within the definition.

There is a surprising deficiency in the tipee provision. Sec. 52(1) of the CJA 1993 creates liability only where an 'individual has information as an insider'. Having information as an insider is specified in s 57. It is necessary not only for the insider, but also for the tipee, to have known the 'information'. Yet, not all tipees come to know the information itself. As a point of fact, the classic 'tip' does not contain inside information as such, but runs, for example, 'buy X Ltd or sell Y Ltd'.[1004] Where such a true tip is passed on, the recipient is outside the provision, as he has not got the 'information', whereas the tipper himself is held liable for 'encouraging to deal'.[1005] This peculiar result is based on the wording of Art 4 of the Directive which stipulates that the recipient must 'with full knowledge of the facts posssess inside *information* '.

1000 Rider and Ashe op cit at 45.

1001 Idem, at 46.

1002 Lord Lowry, in an obiter dictum, [1989] 2 All ER 1 at 7, seemed to indicate that in relation to the phrase 'knowingly obtained' in s 1(3) CSA, the tipee must know from whom he obtained the information. See Tridimas op cit at 855, who rightly suggests that such an approach is over-restrictive.

1003 Tridimas op cit (1989 Modern Law Review) at 855.

1004 Rider and Ashe op cit at 45.

1005 Hannigan op cit at 88.

V. Evaluating the English definition of the insider

1. Some general remarks

We have seen that the Directive leaves most of the conceptual work concerning the insider-definition to the Member States. It is therefore inecessary to consider not only whether the English concept underlying the definition deviates from the Directive, but also whether the definition is coherent in itself. The new law does not make use of the terms primary and secondary insider. This is good because these terms are not helpful.

The law no longer requires that a person is connected with a company to be an insider. Under the old Act, for instance, the employee of Airline A would not have been constrained from buying Airline B´s shares unless the information related to a transaction beween Airline A and Airline B. The effect of the CJA 1993 is to make him an insider of Airline B by virtue of the information he holds[1006], or rather by virtue of his knowledge as an employee of A or B. This is a giant step: conceptually, this moves away from the requirement of the old approach based on fiduciary relationships[1007]. This could result in the application of the market protection approach as suggested by the Directive. The abandonment of the requirement that a person had to be connected with the company in the preceding six months in order to be an insider points in the same direction. It is obvious that there is now a wider insider potential, which corresponds to the market protection approach.

2. The primary, 'access' or 'source' insider

The Criminal Justce Act 1993 has clarified certain matters that were not readily apparent under the former provisions. It is good law that public servants are included as such. One no longer has to establish that they are public servants by statutory instrument under s 2 of the CSA 1985.

The same is true for editors, financial advisors, printers and journalists; for they need no longer be 'connected' with the company. Yet, with journalists and financial analysts there could be a problem with self-generated

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1006 Rider and Ashe op cit at 43.

1007 For the old view see Rider op cit (1977 The New Law Journal).

information. 'Access' to information means that the information must have an existence independant of the person who has acess to it. Two possible interpretations would help to avoid this. Firstly, one can argue that the fact that the information is going to be published does in itself constitute inside information, and hence 'access' can be subsumed under the alternative 'by virtue of the employment'. Secondly, such situations may be covered by the alternative 'through being an employee'.

Nevertheless, this question should not have been left open. We have to wait for the courts to decide and, as Hannigan[1008] puts it, 'a court might bring back an access-type restriction by the back door'. The legislation here does not improve the conceptual inconsistencies left by the Directive, but rather bases itself on the Directive´s relatively vague formulations. The 'access' requirement ought not to be part of the law, because it make sense only where fiduciary principals or companies are protected by insider dealing provision. For the protection of securities markets, however, it is irrelevant whether the person had access to information, or just saw it on the desk of someone who works in the same department.

What is positive is that the English law has extended the scope of the Directive by referring to the employee twice: firstly as an insider 'through being an emplayee' and, secondly, as 'having access by virtue of his employment'. Certainly, this is a step in the right direction.

However, both formulations give rise to interpretational problems. It is not certain whether a person who obtains the information through a wrongful act falls within the ambit of the definition. For an employee, the formulation is sufficiently broad to cover 'access through wrongful act'. For persons who are not employees, however, this is not so clear. This is a shortcoming of the law. The South African definition of the insider, for instance, is sufficiently broad to encompass both.

It is also not certain whether persons who get the information by chance (eg a taxidriver overhearing a conversation of two fiancial advisors) are included. And since the concept is unclear, it is difficult to anticipate how a court would decide this question.

1008 Op cit at 79.

3. The definition extends to tipees

The concept of market protection does not require that the recipient of the information knows who passed on the original information, ie the primary insider at the inside source.[1009] It is clear that tipee liability has been extended because the inside source no longer needs to have a connection with the issuer.[1010] It is a major shortcoming that the tipee must possess the information, for there is no tipee liability when he receives a true tip. In this regard it is impossible to interpret the law according to the intentions of Parliament, because the wording is absolutely clear. This is in line with the Directive, but not with reality, because for the recipient it is the tip which counts, not the information as such. What is even worse is the fact that the tipee must be acquitted even when he admits that his transaction was based on an inside tip. Such legislation cannot be correct.

4. Conceptual evaluation

On principle, the approach which was suggested by the Directive, ie that insider trading restrictions should enhance market protection, is reflected in the English insider definition. Nevertheless, the law does not accomplish the conceptual work which the Directive left it to do.

The problem of the inside information being obtained through a wrongful act was not addressed at all. In this regard, the vague outlines of the Directive are merely copied. Thus we do not know whether situations where information is obtained through misrepresentation or another wrongful act are covered. The same is true where such wrongful acts are committed by employees.

Even though the concept of 'market protection' does not include the protection of business property, it does not exclude the exploitation of information which is business property. The reason is that investors on securities markets do not attach so much importance to the source of the informations. So why not simply include all ways of obtaining information, as long as it is still 'inside'? A good argument for such a position is that, economically, (as we have seen in Part I), it makes no difference who deals on the strength of 'hidden' information.

1009 Under the CSA 1985 this was also not certain, see Tridimas op cit at 855.

1010 Rider and Ashe op cit at 43.

It is regrettable that all persons who obtain inside information through industrial espionage, are excluded from the list of direct insiders. This may turn out to be particularly unhelpful for the realisation of the intentions of the law. If the thief is not an insider, the information does not originate from an inside source. Thus the recipient (eg the person who gave the order to steal the information) is not an insider, and would therefore be free to deal.

It has to be hoped the courts will interpret the statutes in view of the conceptual approach of market protection. The task of incorporating this new concept in the 'insider'-definition has not yet been accomplished. The legislation does not present a coherent picture. It is submitted that the English legislation will have to revise its concepts in order to align the provisions to modern theory.

D. Germany

First an overview of the legislation will be given. The different categories of insiders will be discussed in turn, starting with classic insiders, and then proceeding to tippess and sub-tipees.

I. The text

The definition of the 'insider' is laid down in § 13(1) Nr.1-3 WpHG. The term 'insider' refers to all persons listed in this provision.

> (1) Insider ist, wer
>
> 1. als Mitglied der Geschäftsführung- oder Aufsichtsorgans oder als persönlich haftender Gesellschafter des Emittenten oder eines mit dem Emittenten verbundenen Unternehmens,
>
> 2. aufgrund seiner Beteiligung am Kapital des Emittenten oder eines mit dem Emittenten verbundenen Unternehmens oder
>
> 3. aufgrund seines Berufes oder seiner Tätigkeit oder seiner Aufgabe bestimmungsgemäß
>
> Kenntnis von ... hat, ...[1011]

This definition is more or less the same as in the Directive, with one major exception, ie No 3 which stipulates that an insider is only who 'by virtue' of his profession or the exercise of his duties possesses inside information.

This formulation seems to exclude all people within a company or an enterprise who do not have access to information as a result of their job. For instance, someone who misappropriates inside information, to which he has not normally access, would not seem to be caught as an insider, for he would not fall within the definition. This result is not in line with the Directive,[1012] and it is certainly not very sensible.

1011 English as translated by Mohr op cit at 81 et seq.:

> (1) An insider is any person who
>
> 1. as a member of any managing or supervisory organ or as a personally liable partner of an issuer or of an enterprise connected with an issuer,
>
> 2. by reason of his participation in the capital of the issuer or of an enterprise connected with the issuer or
>
> 3. by reason of his profession, business or function and when executing his

The second part of the definition of the insider is contained in § 14(2) WpHG which runs:

> Einem Dritten, der Kenntnis von einer Insidertatsache hat, ist es verboten, unter Ausnutzung dieser Kenntnis Insiderpapiere ... zu erwerben ....[1013]

This formulation is intended to catch tipees, but the provision is deficient because it does not with sufficient clarity define the way, in which the 'third party' must come into possession of the information.

II. The structure of the definition and market protection

The definition does not even attempt to introduce a coherent concept to the wording of the Directive which is copied. Both forms of defining insiders, ie enlisting company insiders and extension through a general criterion, are maintained. The provision falls short of the Directive in that company insiders are caught only if their employment gives them access to the information. This seems to emphasize the fiduciary relationships, although the element of confidentiality has clearly been eliminated.

If the legislation is really intended to protect markets, it should not have re-introduced such old elements via a side entrance. Conceptually, the definition is defective, bearing in mind that the protection of the market is no less urgent in situations where the information is stolen.

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appointed activities

has knowledge of a fact (...).

As for No 3, the present writer suggests that a more appropriate translation would be 'by virtue of his profession, employment or the exercise of his duties'. Otherwise the translation would result in a deviation from the official English version of the Directive although the German text is identical.

1012 For an intensive criticism of this departure from the Directive see Hopt op cit (WM-Festgabe) at 30.

1013 English translation by Mohr op cit at 83:

(2) It is forbidden for a third party who has knowledge of an isider fact to acquire or dispose of insider securities ....

III. The insider as defined in §§ 13, 14 WpHG

By and large, the definition resembles the English one because it is also based to a high degree on the Directive. We shall examine at more length the deviations from the Directive, and the differences from the English law.

1. Insider 'through' professional activities

It is obvious that the classic concept of primary and secondary insiders has been abandoned. Those who obtain information by reason of their professional duties or through being directors do not represent a 'homogenous' group of persons. The provision includes equally those who are managers in an enterprise and those who work there as secretaries.[1014] The breadth of the formulation has given rise to the same sort or fears in the City of Frankfurt as they did in the city of London.[1015]

a) Directors, managers, and liable partners

An insider is any person who has knowledge of a non-public fact as a member of a managing ('Vorstand'), or supervisory ('Aufsichtsrat'[1016]) organ, or as a personally liable partner of an issuer or of an enterprise connected with an issuer.[1017] A fiduciary relationship is not required[1018].

aa) Directors of the enterprise

The first group encompasses insiders within the company: directors, managers, liable partners. All these people are classic insiders.[1019] It is important to note that the prosecution must prove that the person had the

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1014 See Claussen op cit at 271.

1015 See Ernst, WM 1990 at 461: 'Alle Börsianer zukünftig Insider?' (all stock exchange people insiders in future?').

1016 The first famous insider case in Germany was the Steinkühler-case. Mr Steinkühler was a trade union member of the 'Aufsichtsrat' of Daimler Benz, cf FAZ Nr. 114 of 18 May 1993 at 13 et seq. For an analysis of the duties of the 'Aufsichtsrat' see Lutter, 'Information und Vertraulichkeit im Aufsichtsrat', 2nd edition, 1984.

1017 § 13(1)(No 1) WpHG.

1018 Assmann and Schneider op cit (Wertpapierhandelsgesetz) at 101.

1019 Pingel op cit at 10.

information and that he had it 'through being' a director or liable partner.

bb) Directors of a connected enterprise

The second group consists of insiders who work for another company. A director or manager is an insider not only with regard to his own company, but also with regard to a connected company. This element extends the definition of the Directive which stipulated in its Art 2(1) that an insider is someone who is director or manager of 'the' ie his own company. One needs to define circumstances where a company is 'connected' to another company. Since there is no explanation in the WpHG, the literature refers to the definition contained in § 15 AktG.[1020]

b) Shareholders

Shareholders have sensibly been included[1021] in the definition, since they can influence[1022] the actions of the company. This part of the definition is also perfectly in line with the Directive. Every shareholder is a potential insider. The prosecution must prove the link of causality between the person having the information and his position as a shareholder. There is no need to refer only to substantial shareholders nor to set a limit of the share position.[1023] This is certainly correct, because it is in line with modern economic theory, according to which it does not really matter who carries out the share transactions, as long as they are based on inside knowledge.

c) Profession, business or function

An insider is also any person who, by reason of his profession, business or function and when executing his appointed activities (the German text says: 'wer *bestimmungsgemäß* Kenntnis hat'), has knowledge of inside information.[1024] This formulation may cause problems. The deviation from

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1020 Assmann op cit (ZGR 1994) at 505.

1021 § 13 I Nr. 2 WpHG.

1022 According to Lutter, 'Zur Treuepficht des Großaktionärs', JZ 1976 at 225, the influence of substantial shareholders should correspond to their (fiduciary) duties.

1023 BT-Drucks 12/6679 at 46; Assmann op cit at 506.

1024 § 13 I Nr. 3 WpHG.

the Directive was intentional[1025] and has been criticised by Hopt.[1026]

It is under this category that we must subsume the secretary when she types a document which contains price-sensitive information.[1027] And, apart from the secretary, all persons fall within the scope of this category who have certain functions which give them access to information. Such persons are consultants, lawyers, financial service people and so forth. It must be noted, however, that they become insiders if, and only if, their access to the information is part of their regular job, ie they obtain the knowledge 'when executing' their appointed activities.

This formulation results in two very important restrictions. Firstly, a person whose employment does not as such open access to information does not fall within the definition. Such persons are cleaners and trainees from another department of the firm. The above-mentioned barman, for instance, who overhears a conversation of two senior executives, is not an insider, because his employment does not provide access to sensitive information. Yet, he may be caught by the wider formulation in § 14(2) WpHG as 'a third party who has knowledge of an insider fact'; if so, however, he is as a recipient who is not forbidden to communicate the information to another person. This problem will be dealt with below in the rubric 'tipees'. As far as cleaning personnel or the barman are concerned, the fact that they are not included is perhaps not so important.

Secondly, and probably more importantly, is the fact that the information must be obtained 'when executing his functions'. This is very restrictive because any person who works within an enterprise is an insider if and only if his own duties give access to price-sensitive information. Even a clerk who works at the other end of the desk is not included. Compared to the former English law which stipulated that a person had to be connected with a company, the German formulation is even more restrictive. The person concerned must know about the insider fact because that fact is 'connected' to his personal work within the company. This is a questionable approach.

But the problems do not stop at this point. A person who knows the insider fact through a wrongful act (for instance, the secretary or the clerk who,

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1025 Official reasons, BT-Drucks. 12/6679 at 46.

1026 See Hopt op cit (WM-Festgabe).

1027 See Claussen op cit at 271.

without permission, opens a document on the desk of another employee) is not within the provision. At best these persons could be regarded as recipients or tipees under § 14(2) WpHG. But then they are liable only for procuring the information, which renders their liability in fact incomplete.

2. 'Dritte' (ie third parties), die Insiderkenntnis haben (ie who have knowledge of an insider fact)

A third party who has knowledge of an insider fact is prohibited from acquiring or disposing of insider securities ... by exploiting such knowledge.[1028] This provision is aimed at tipees.[1029] The inclusion of these 'third parties'[1030] was much debated in the course of the legislative preparations. The Government, at a certain stage, was reluctant to even include tipees at all. Fortunately, this idea was dropped.

The present formulation is very wide and seems to include anyone who is in possession of inside information. This again is a major deviation from the Directive which provided in its Art 4 to include persons other than those dealt with hereinbefore who

> 'with full knowledge of the facts possess inside information, the direct or indirect source of which could not be other than a person referred to in article 2 (ie insiders through their profession or work)'.

The only thing which is now required by the German law is that the third party has knowledge of an inside fact without knowing how the information

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1028 § 14(2) WpHG, (dt.:): 'Einem Dritten, der Kenntnis von einer Insidertatsache hat, ist es verboten, unter Ausnutzung dieser Kenntnis Insiderpapiere ... zu erwerben oder zu veräußern.'

1029 For German comments on the tippee-issue see, above all, Hopt op cit (BFuP 1994) at 91; see also Hopt op cit note 141 at 35 et seq., and at 47 (sub 'Tipping').Hopt argues that the tippee-issue is not so important. Given the economic apects (above all the 'derivatively informed trading'), however, the tippee-problem is certainly more than a mere 'Nebenkriegsschauplatz', and Hopt probably underestimates the importance of the tipee-issue.

1030 For an interesting comparative overview see Siebel 'Der Sekundär-Insider', in: Bierich/Hommelhoff/Kropff (eds), 'Unternehmensführung im Recht', Festschrift für Johannes Semler zum 70. Geburtstag am 28. April 1993, Berlin, 1993 at 955.

was obtained.[1031] Assmann[1032] suggests that it is irrelevant where the information stems from or who was at the source of it.

Since a national law must be interpreted in the light of the Directive, Assmann´s view cannot be correct. The German Courts are able to re-introduce the omitted requirement of the 'inside source' when tipee liability is at issue. And, in practice, it is very difficult to establish whether or not the window cleaner (or the barman) dealt on the strength of hidden information without knowing that the information was inside, ie that it originated from an inside source.

Other persons who obtain the information by mere coincidence should not be included, because they have no responsibility for the proper functioning of the securities markets, and can therefore not really damage it. In terms of market protection, it would make sense to include only those persons who have such responsibility because only then could they really carry out transactions which affect the market in a negative way - and thus be detrimental to both the functioning of the market and investor protection in the democratic sense developed in Part I.

Another serious shortcoming of the German legislation is the same as that to be found in the English legislation. The law stipulates that the tipee (the 'third party') is forbidden to acquire or dispose of securities, if he has knowledge of an insider fact.[1033] Thus the tipee will not fall foul of the provision if he is (whether as a matter of fact or because the prosecution fails to prove the contrary) in possession only of a valuable tip such as 'it is profitable to buy the shares of XY now', but not of the information as such. In most cases, however, this is exactly what happens because the recipient of such a tip is not really interested why he should buy as long as the source of the tip is reliable.

1031 Claussen op cit (DB 1994) at 28; Assmann op cit at 508 follows that view.

1032 Idem at 508 et seq.

1033 § 14(2) WpHG.

IV. The value of the German insider-definition

1. Direct insiders

The 'direct' or 'source' insiders are correctly not called primary insiders. Apart from the terminological benefits, however, the provision contains several shortcomings, some of which are major.

Even managers or directors who obtain the information through a wrongful act, eg espionage, do not fall within the ambit of the definition. They must have the information as a result of their position. They may be caught as tipees, but this does not seem to make much sense. This is regrettable because it does not effectively protect the market.

Unlike the definition in the Directive the employee is caught if, and only if, he has access to the information when executing his appointed functions. This restriction stipulated by the German law does not correspond with the European law, and does not fit in the conceptual framework. Where market protection is envisaged, the legislation should have included employees, irrespective of where the information originates from, as long as informational imbalances are exploited.

2. The so-called 'tipees'

The tipee provision is very defective. An interpretation which sticks to the letter of the law will result in almost everybody being caught by the term 'third party', irrespective of their profession, function or responsibility[1034] for the market. This even includes managers who misappropriate the information, and who, instead, should be caught as 'direct' insiders. The fact that they merely are within the scope of the tipee provision privileges persons who obtain the information through a wrongful act. What is more, these persons are not even prohibited from counselling or procuring the information. This cannot be good law.

Any share transaction which is based on a true tip is excluded from the prohibition. This excludes most forms of classic tipping. As in the new English law, this is a result of the formulation provided by the Directive.

1034 The aspect of responsibility will be introduced below when we consider a new conceptual approach to the insider definition.

The text of the national law ought to be amended. This is possible because the scope of a Directive is only a minimum standard. The national law should not be less inclusive than the Directive, but can certainly be more far-reaching. Another argument to extend the provision is that the German courts cannot broaden the scope of the criminal statute through teleological interpretation. The legislator should have provided that the scope of the tipee provision is narrower and that, on the other hand, all tipees are prohibited from procuring and counselling.

3. Conceptual criticism

The definition is in itself neither in line with the envisaged market protection approach, nor does it correspond to the wording of the Directive in its decisive passages. On the whole, the conceptual work that was left to be done by the Member States has not been accomplished, neither with regard to direct insiders nor to tipees. It has in fact been accomplished to an even lesser degree than in England.

Particulary the fact that the employee must have the information through his regular work makes it obvious that this part of the definition is based on the old fiduciary concept rather than on market protection. It was the declared intention to give up the old approach in favour of market protection. The result, however, is unsatisfactory. It is not apparent which new concept replaces the old one. The whole text lacks sufficient clarity to enable one to determine with precision who is an insider and who is not. This is particularly regrettable because in German criminal law it must be proved that the accused violated the good or value (dt.: Rechtsgut) which is protected by the provision. And this, of course, is very difficult when the value or good itself is not properly defined.

Where the German insider definition sticks to the Directive, it merely copies its text without truly realising the concept of market protection. Deviations from the Directive result in some major shortcomings. Here again, the only excuse is that this is the first legislative attempt to cope with the problem of insider trading.

Chapter 4: Offences and defences

After the comparative examination of elements of inside information and of who actually is an insider, we must now consider the kinds of transactions such persons are prohibited from carrying out.

Economically, there are certain limitations as to how and when inside information can be exploited on securities markets. Insiders have to act quickly - otherwise, in competitive markets, other market participants make the profit. Their first alternative is to buy or sell securities, options or futures etc. Insiders can do so on their own account or on someone else´s. In both cases it is obvious that the market can be affected in a negative way, if it is affected at all. If the insider buys on someone else´s account, the transaction as such remains the same.

Their second alternative is to refrain from trading eg buying stock when they know that negative information is about to be published. Incidentally, this is an important[1035] form of insider trading that no one can do anything about. Take for instance the fund manager in whose portfolio the stock is already contained. The stock may be sold or not as conditions dictate. However, with inside information, the manager would know when to sell and when not to. Whether the market is affected or not by abstaining need not be considered, because the omission to transact has never been criminalised by any legislation. The reason for this is very simple: it is impossible to prove.

Thirdly, the information can be passed on to others, either as such or as a 'tip' which is based on the information. For this purpose the information can be sold or it can be given gratuitously to a relative or a friend. In Part I of this study it was found that, if those recipients effected securities transactions, they would harm the market just as much as would the insider himself. Tipee trading is probably more harmful. Insiders who trade enhance price efficiency because they trigger derivatively informed trading. Tipee trading does not have this positive effect, because they are seldom identified as informed traders, hence they do not 'signal'[1036].

1035 See Manne op cit (Cato Journal) at 939, who states that this is the form of insider trading that may be the dominant method of using inside information.

1036 On 'signalling' see above in Part I, chap 2, D, V, 1.

The imparting of the information itself does not directly affect the functioning of the market. It would therefore seem illogical for the imparting of the information to be criminalised. However, procuring or counselling on the strength of inside information enlarges the circle of people who are able to exploit the information. No-one can ever be certain of the number of people who possess inside information due to imparting and procuring. The uncertainty about the risk to the market provides a strong argument in favour of extending the prohibition to imparting.

We shall now compare the varying degrees to which the three laws have criminalised the behaviour of persons who misuse inside information, whether through acting (directly or indirectly) on the stock market or through imparting their knowledge.

A. South Africa

The present South African law has brought about some important changes to the pre-existing law. In general, liability has been extended.

I. The offences

1. What is prohibited?

With regard to the actual prohibition the South African key provision provides that 'any person who, whether directly or indirectly, knowingly deals in a security on the basis of ..., shall be guilty of an offence if such person knows that ... .[1037] One of the major difficulties for the prosecution is to prove that the defendant dealt *on the basis* of information. We shall later consider the way[1038] the South African law seeks to facilitate this. It has to be noted that no offence is committed if the insider merely decides on the basis of inside information not to deal, even though, if he had not possessed that information, he would certainly have dealt. That approach is correct.

The law prohibits direct and indirect dealings 'on the basis' of inside information. This formulation gives rise to the question whether dealing on

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1037 Sec. 440F(1) of the Companies Act 61 of 1973.

1038 See below sub '6'.

the strength of pointed hints (ie so-called 'true tips') and recommendations eg 'buy shares in X' are included.[1039] Jooste[1040] suggests that the friend who received the true tip deals 'indirectly' on the strength of the information which forms the basis for the hint or recommendation.

Although, no doubt, it was the intention to include such deals, the text of the law does not so provide. Sec. 440F(3) of the Companies Act provides certain rebuttable inferences sub conditione that 'it is proved that: (a) 'the accused was in possession of unpublished price-sensitive information ...'. This formulation, which is aimed at facilitating the prosecutions's burden, makes it abundantly clear that one thing must always be proved, namely the possession of information. Dealing on the basis of tips is therefore not caught by the present legislation. This is an important issue for the tipees.

2. Changes to previous legislation

Unlike the old s 233, s 440F of the Companies Act makes secondary insider dealing an offence, too. The old legislation only included dealings in 'shares or debentures', although Henochsberg[1041] took the view that s 233 encompassed the act of procuring or exercising an option to purchase shares, or the sale of such option. The latter was probably not included, because selling an option is dealing in a *right* to buy or sell shares, not, however, dealing in shares. The new provisions encompass both.

Yet the most significant change is the fact that the law no longer requires that the insider deals in any way to his advantage. Although the old requirement was said to be suitably broad in this respect, it would have been difficult to establish this element in practice.[1042] The abandonment of this requirement conceptually results in the new definition of price sensitivity which is now defined as '... reasonably be expected to affect materially the price ...'.[1043]. An insider would probably not have been caught under the old law, if he had waited until the price shift had occurred, or, in case he suspected an inquiry against him, if he had sold the

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1039 Jooste op cit (1990 SALJ) at 597.

1040 Idem at 597.

1041 See Henochsberg on the Companies Act 4 ed (1985) ed Philip H Meskin at 371.

1042 Rider op cit (1977 SALJ) at 444.

1043 Sec. 440F(2)(a)(iii).

information before the actual price shift took place. The result of the new law is that it is neither necessary for an actual price shift to occur, nor for the insider to have retained a profit.

3. Mens rea

The use of the word 'knowingly' in s 440F(1) of the Companies Act makes it clear that mens rea is a sine qua non for the offence to be committed.[1044] The word 'knowingly' is one of the clearest indications that mens rea is an element of the offence.[1045] It also implies that the required form of mens rea is dolus[1046] rather than culpa.[1047] Henochsberg[1048] says that intention to deal in contravention of the section is a prerequisite for a conviction. It would, however, not be essential for the accused to be aware of s 440F or of the particular penalties for the contravention of s 440F.[1049]

4. Dealing in a 'security'

'Security' does not only mean shares. It also includes stock and debentures convertible into shares, and any rights or interests in a company, or in respect of any such shares, stock or debentues. It further includes any 'financial instrument' as defined in the Financial Markets Control Act, 1989 (Act No 55 of 1989).[1050] In terms of s 38 of Act No 55 of 1989[1051] options on stock or shares or on debentures, notes or units and rights thereto, futures, options on indices and so forth are clearly included.[1052] This list is fairly complete and rightly implies that inside information can be exploited by dealing in practically all securities. The dealing in

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1044 See Jooste op cit at 592.

1045 See Gaumont British Distributors Ltd v Henry [1939] 2 All ER 808.

1046 Dolus directus and dolus eventualis, see Jooste (The criminal aspects) at 23.

1047 See S v Bezuidenhout 1979 (3) SA 1325 (T) at 1327F-G.

1048 Op cit (Companies Act 5th ed) at 977.

1049 See Jooste op cit at 592.

1050 Sec. 444A(1) sub 'security'. The definition of 'security' was substituted by s 1(f) of Act 69 of 1990 with effect from 1 Feb 1991.

1051 Sec. 1 'Definitions' of the Stock Exchanges Control Act No 1 of 1985.

1052 See, however, the doubts expressed with regard to the scope of the term 'security' by the King Task Group op cit at 10.

members´ interest in a close corporation is, however, exempted,[1053] although such a corporation is in fact a corporate body[1054].[1055]

5. What are 'indirect' dealings?

The law further prohibits 'indirect' dealings.[1056] This formulation is said to cover the acquisition and exercise of options and pre-emption rights relating to shares or debentures.[1057] It is submitted that such an interpretation would still be based on the incomplete list of securities under the old legislation. There is no need to further extend the term 'security', because the present law indeed includes all relevant securities. Hence, the question arises, what is an 'indirect' dealing?

The Report of the Commission of Enquiry into the Companies Act[1058] had already considered this.[1059] Although the Report resulted in the formulation 'deals in any way to his advantage, directly or indirectly', it seemed that indirect deals were included by the legislation. Thus the interpretation of the present law can refer to that under s 233, in terms of which indirect dealing meant to cover situations where nominees, spouses, or children were used. It is submitted that the term 'indirect' dealing in s 440F(1) is also meant to cover these[1060] situations.

6. Facilitating the prosecution´s burden of proof

The South African law provides a certain facilitation for the prosecution. It provides that, 'if at criminal proceedings at which an accused is charged with an offence ... it is proved that (a) the accused was in possession of ... information ...; or (b) ... information was obtained ..., he or she shall be deemed, unless the contrary is proved, ... to have knowingly dealt in that

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1053 Sec. 440F(5).

1054 See s 2(2) of the Close Corporation Act 1984.

1055 Henochsberg op cit at 976.

1056 Sec. 440F(1) of the Companies Act 61 of 1973.

1057 Jooste op cit at 593.

1058 Van Wyk de Vries Report, RP 45/1970.

1059 Rider op cit at 444.

1060 Henochsberg op cit at 977 says that nominee-situations are within the ambit of the prohibition.

security on the basis of such information; ... to have known that such information was so obtained.[1061]

This rebuttable inference in s 440F(3) formulates in a statute what was ruled in the decision S v De Blom.[1062] To dispel the inference, the accused must produce evidence that he did *not* know that his act was contrary to law. He would, for instance, lack knowledge of unlawfulness where he acts 'under bona fide ignorance of the law'. Jooste[1063] suggests that such ignorance could exist simply because the accused is unaware of the existence of s 440F, or because he has been wrongly advised.

7. Counselling and procuring

The insider who passes on the information to an outsider is not guilty of an offence, even if the outsider commits an offence on the basis of the information. For example, where a director passes on price-sensitive information to a friend, fully aware of the fact that this friend will deal, he himself does not contravene s 440F.[1064]

II. Offences that can be committed by tipees

The South African law treats tipies like insiders. The recipients of inside information are prohibited from dealing. They are, however, not held liable when they deal on the strength of a true tip. Like insiders they are not prohibited from counselling and procuring the information.

III. Is the penal net cast widely enough?

It was observed that the intention of the legislation was to cast the penal net widely.[1065] This view is supported by the fact that the law does not provide any defences. The law addresses neither the problem of imputation of knowledge within financial conglomerates, nor the issue of situations with

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1061 Sec. 440F(3).

1062 1977 (3) SA 513 (A); see Jooste op cit at 592.

1063 See Jooste, idem at 592.

1064 Jooste, idem at 596. See also the King Task Group Report op cit at 14.

1065 Henochsberg op cit at 976.

potential conflicts of interest.[1066] Would, for instance, a defence be available for a bank´s retail department, if inside information were used in favour of a client to whom they owe full disclosure? Should the bank be encouraged to erect a chinese wallin order to prevent[1067] the information from penetrating the retail department?[1068]

It is a serious shortcoming that no prohibition is imposed on the insider who passes on the information, even if the outsider were to deal on the strength of the information.The fact that counselling and procuring are not outlawed is suprising. The law provides that insiders must know where the information stems from. Thus it would seem that the prosecution must uncover the source. But then, of course, the source can be prosecuted as well.

The above omission is all the more surprising since the legislation intended to protect investors against the misuse of inside information. The more the information spreads the more it is likely to be misused. It seems obvious that the scope of the prohibition should be extended to include the act of imparting inside information.

1066 See Jooste op cit at 597 et seq.; above all see the excellent book by Goode (ed), 'Conflicts of interest in the changing financial world', London, 1986; these conflicts need not necessarily be addressed by statutory rules, however, since South African financial institutions may also adopt self-regulatory measures, see Malan, 'Legal aspects of the regulation of financial institutions', TSAR 1989 at 553.

1067 For arguments against full imputation of knowledge see Hagemann/Grinstein, 'The mythology of aggregate corporate knowledge: A deconstruction', vol 65 George Washington Law Rev 1997, 210 at 218 et seq.

1068 With regard to the 'Chinese Wall'-problem see for an English point of view McVea op cit (Financial conglomerates); for a German perspective on this manifold problem see Tippach op cit at 231 et seq.

B. The European Directive

I. Transactions by insiders which are prohibited

The Directive cannot prohibit any transaction in the sense that the prohibition is directly[1069] applicable. Instead, the prohibitions provided by the Directive must be enforced by each Member State.[1070] Their laws can be stricter, and the range of prohibited transactions wider[1071].

Essentially, there are three prohibitions set out in the Directive.[1072] Firstly, persons who possess inside information shall be prohibited from taking advantage of that information by acquiring or disposing of - for his own account or for the account of a third party - transferrable securities of the issuer or issuers to whom that information relates.'[1073] This applies only when the insider deals with full knowledge of the facts. Consequently, it must be shown that the insider acted wilfully; mere carelessness while in possession of inside information is not enough.[1074]

The term 'transferrable securities' as defined in Art 1(2) of the Directive includes, amongst others, shares, debt securities, contracts or rights to subscribe for, acquire or dispose of such securities, future contracts, options and financial futures in respect of such secutities, and index contracts in respect of such securities. The definition is sufficiently broad,[1075] and thus the prosecution, if it fails, will certainly not fail because the security which was the object of the alleged insider deal has not been included in the law as an 'insider security'.

Secondly, the insider shall be prohibited from disclosing inside information to any third party unless such disclosure is made in the normal course of the

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1069 See above, Part II, chap 1, B.

1070 Art 2(1) runs: 'Each Member State shall prohibit any person who ...'.

1071 Art 6 runs: 'Each Member State *may adopt* provisions more stringent than those laid down by this Directive or additional provisions ... . In particular it *may extend the scope of the prohibition* laid down in Art 2 ... .' (The emphases are mine).

1072 Ashe op cit (The Directive) at 18.

1073 Art 2(1) of the Directive.

1074 Ashe op cit at 18.

1075 Ashe, idem at 18.

exercise of his employment, profession or duties.[1076] Unlike the South African concept, this approach is well defined: the protection of the securities market requires that the source of the inside information must not divulge its knowledge. It is interesting that the Directive takes into account that there are certain professional duties[1077] which require that information is disclosed, eg information has to be registered with an administrative body or must be disclosed during a criminal inquiry or prosecution.

Thirdly, the Member States shall prohibit insiders from recommending or procuring a third party, on the basis of that inside information, to acquire or dispose of transferable securities ...[1078]. Thus not only passing on the information as such to others is a prohibited action under the European law, but also using the information for 'inside' recommendations.

II. Transactions by persons other than primary insiders

The Member States must also impose the prohibition provided for in Art 2 (ie the dealing prohibition) of the Directive on any person other than those persons referred to in that article who, with full knowledge of the facts, possesses inside information, the direct or indirect source of which could not be a person other than a person referred to in Art 2 (ie a primary insider).[1079] Each Member State may ... impose on persons referred to in Art 4 (ie the so-called tipees) the prohibitions laid down in Art 3 (ie disclosing, procuring and recommending).[1080] It has to be noted, however, that the Directive only requires recipients of information to be prohibited from dealing, not from procuring or counselling.

1076 Art 3(a) of the Directive.

1077 For a factual example see R v Fisher [1988] 4 BCC 360.

1078 Art 3(b) of the Directive.

1079 Art 4.

1080 Art 6.

III. The Directive as a source of national laws

As we have seen above, both the prohibition imposed on insiders and on tipees leave much legislative work be done by the Member States. Moreover, neither general nor special defences have been provided by the Directive. This was a wise step because it is particularly difficult to outline offences and defences, given the fact that penal law falls within the competence of each Member State, and can therefore not be harmonised by a Directive.

C. England

It is helpful to start our examination with the English provisions because they are much more detailed than the German statutes.

I. Insider offences under the English law

Like in the Directive, the CJA 1993 provides three different offences committable by insiders. Some differ in wording from the Directive due to the implementation process of the Directive. Under the English provisions the following are considered wrongful acts: disclosing the information, dealing on the strength of it, and encouraging others to deal (or to counsel).

The prohibitions apply only to individuals, thus a company cannot be charged. However, those who procure a company to deal, eg managers, are certainly within the scope of the prohibition,[1081] although they do not act on their own behalf. It is also very important to note that the prohibitions apply to both direct insiders and tipees.

1. Territorial scope of Part V of the CJA 1993

The territorial scope of the English provisions is uncertain. The purpose of the Directive was to create a community-wide system of insider dealing regulations.[1082] One must ask therefore whether 'dealing on a regulated market' (this is the formulation used by the Directive) encompasses dealings outside a national jurisdiction once the Directive is implemented, and the national law has merely copied this formulation. The term 'regulated markets' would certainly emcompass markets outside the UK. Yet the Criminal Justice Act 1993 requires a territorial link between the insider offence and the UK. The intention of this is to prevent certain forms of insider dealing[1083] eg insider dealing on other regulated markets through the use of professional intermediares based in the UK.

To commit the dealing offence (as opposed to the disclosure or the

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1081 Hannigan op cit at 91; for the potential danger created by companies purchasing or redeeming their own shares see Cranston, 'Insider dealing again', (1990) Journal of Business Law at 444.

1082 Gore-Browne op cit at 12.044.

1083 Parliamentary Debates, HL, 19 Nov 1992, col 774 (per the Earl of Caithness).

encouraging offences) it is necessary for the insider that

(i) he was within the UK at the time when he is alleged to have done any act constituting or forming part of the alleged dealing;[1084]

or

(ii) the regulated market on which the dealing is alleged to have occurred is one which, by an order made by the Treasury, is identified (whether by name or by reference to criteria prescribed by the order) as being, for the purpose of this Part, regulated in the UK;[1085]

or

(iii) the professional intermediary was within the UK at the time when he is alleged to have done anything by means of which the offence is alleged to have been committed.[1086]

The disclosure and encouragement offences cannot be committed unless the insider is within the UK when he discloses the information (or encourages others to deal), or the recipient of the information (or encouragement) is within the UK when he receives the information.[1087]

Tipping persons overseas from the UK by telephone would therefore be within the insider dealing offence, and so would be tipping a person within the UK jurisdiction from a telephone abroad.[1088]

The following examples probably fall within the territorial scope of the CJA 1993 if all the other requirements are met:[1089] dealing in securities of a UK company on the London Stock Exchange; or of a French company on the London Stock Exchange; telephoning from the UK an order to purchase securities of a company listed in a European Stock Exchange; dealing in Spanish Government stock in London; an Irish dealer who relies on a London intermediary to deal in shares quoted in Dublin; English resident dealer who relies on an intermediary based in Northern Ireland to buy shares listed in Frankfurt; UK resident agreeing by telephone to make a

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1084 Sec. 62(1)(a) of the CJA 1993.

1085 Sec. 62(1)(b).

1086 Sec. 62(1)(c).

1087 Sec. 61(2).

1088 Rider and Ashe op cit at 60; see also Gore-Browne op cit at 12.044 et seq.

1089 Rider and Ashe op cit at 59.

contract for differences in New York; French resident, dealing in a French security listed in London; UK resident, procuring his Cayman company to deal in securities on diverse markets.

2. The dealing offence

The primary prohibition is cast on dealing on the strength of inside information. But which actions are included in this general formulation?

A person 'deals in securities' if (i) he acquires or disposes of the securities (whether as principal or agent);[1090] or (ii) he procures, directly or indirectly, an acquisition or disposal of the securities by any other person.[1091]

It does not need to be shown that the insider dealt *because of* the inside information. It is sufficient to prove that he was an insider as defined by the law, and that he dealt at a time when he had such information. This avoids the difficult problems of proof which would otherwise arise.[1092]

A person 'deals in securities' if he acquires or disposes of these whether as principal or agent. In a situation where a securities firm´s employee deals, not on his own account, but on the firm´s account, the employee is liable even though he dealt as an agent[1093] and even though he did not gain from the transaction.[1094]

This formulation also covers situations where an agent deals on an execution basis[1095] (ie he carries out an order by his principal). It would seem unfair to the principal who gave the instruction without having inside information, if the agent then feels inhibited from carrying out the order. For cases like that a special defence (see text below) is available for principal/agent situations. This defence allows the agent to act on instructions[1096] - so long as the agent does not *use* the inside information.

1090 Sec. 55(1)(a).

1091 Sec. 55(1)(b).

1092 Hannigan op cit at 92.

1093 Hannigan op cit at 92 et seq.

1094 Rider and Ashe op cit at 48.

1095 Rider and Ashe, idem at 48.

1096 Rider and Ashe, idem at 48.

a) Acquisitions and disposals

Acquisitions and disposals are the central issue of the matter. But not all acquisitions or disposals are direct. 'Acquire' includes:

(i) agreeing to acquire the security;[1097] and

(ii) entering into a contract which creates the security.[1098]

'Dispose' includes agreeing to dispose of the security;[1099] and bringing to an end a contract which created the security.[1100]

Subpoint (i) covers situations not only where the dealer acquires or disposes of legal title to the securities, but also where the dealer has only agreed to acquire or dispose of the securities because he has bought and sold in the same account, without ever actually taking legal title to the security.[1101]

Subpoint (ii) takes into account that in the derivative markets there are no securities to be acquired or disposed of, but entering into the contract has the effect of creating a new security. This applies particularly to dealing in options, index contracts and other contracts for differences.[1102]

b) Procuring an acquisition or disposal

A person also deals in securities if he procures, directly or indirectly, an acquisition or disposal of the securities by another person. This is important because it covers numerous situations where the insider does not deal himself but through an agent, a nominee or a third party.[1103] The other person can be his agent, his nominee or a person who is acting 'at his direction',[1104] although these examples are not exhaustive.[1105] Also, situations are covered in which a principal who is an insider persuades an

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1097 Sec. 55(2)(a).

1098 Sec. 55(2)(b).

1099 Sec. 55(3)(a).

1100 Sec. 55(3)(b).

1101 See HC Debates, Session 1992-93, Standing Committee B, col 168, 10 Jun 1993.

1102 HC Debates, idem.

1103 Hannigan op cit at 93.

1104 Sec. 55(4)(a)-(c).

1105 Sec. 55(5).

innocent agent, eg a professional dealer or simply a friend to deal for him.

Another example would be an insider who deals through a company which he controls. Here the insider procures the dealing by means of another person acting at his direction.[1106]

Some disquiet was expressed in the House of Commons Standing Committe B[1107] at the scope of the formulation 'at his direction'. It was said that this might include - what is not intended - a person who has inside information but whose investment portfolio is handled by someone else on a discretionary basis (eg by a fund manager). The Economic Secretary, in reply, stated that, apart from the fact that there is a statutory defence (s 53(1)(c), see text below), the person who gives a general direction to another to manage his affairs, would not have 'directed' and therefore not have procured. This is certainly correct because the information must be exploited in some way to give rise to a sanction. And without a 'specific' direction to deal, there would be no such exploitation.

c) Price-affected security

Sec. 56(2) of the CJA 1993 provides that securities are 'price-affected' by inside information only if the information, if made public, would be likely to have a significant effect on its price. This broadens (ie compared to the CSA 1985) the prohibition so as to cover dealings in *any* security which is price-affected.

This requirement generates an interesting side effect. If the information is about company A which is a component of the FT-SE 100 Index, an insider is prohibited to deal in securities of A, but he can deal in an index option, since the Index is not a price-affected security in relation to that information.[1108]

The offences contained in the old legislation (ie the Company Securities Act 1985) covered transactions in share debentures, options, and contracts for differences. Art 1(2) of the Directive provided that any dealing in 'transferrable securities' has to be prohibited. As a result a number of

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1106 Hannigan op cit at 93.

1107 Col 167 (per Ainswoth MP).

1108 See Hannigan op cit at 94; see also DTI Consultative Document, 'The law on insider dealing', Dec 1989 paras 2.19, 2.20.

securities had to be added by the new law. Now futures, warrants, most derivatives[1109], depository receipts, loan stock, or gilts issued by central government, other public bodies[1110], local authorities and the Bank of England,[1111] are also covered.[1112]

However, unit trusts, currency and commodity derivatives remain excluded from the prohibition.[1113] So do commodity futures and commodity options[1114]. This would seem to conflict with the term 'regulated market' used by the legislation. Since commodity options are traded on regulated markets, it is not apparent why they were excluded. Actually, the omission is regrettable because commodity options can yield enormous profits.

Another point of criticism is that price-affected securities must not only be listed in Sched 2, but must also meet the conditions specified by the Treasury by statutory instrument.[1115] This formulation is likely to create confusion because a security may be mentioned in the Schedule but is nevertheless excluded via Treasury instrument. This could prevent dealings which are not prohibited by the law. Since dealings enhance the liquidity of the markets, this is contrary to the intended protection of the market.

The relevant statutory instrument issued by the Treasury is 'The Insider Dealing (Securities and Regulated Markets) Order 1994' (SI No 187) which came into force on 1 Mar 1994. According to Sched 2 the security either needs to be listed in a State within the European Economic Area, or it has to be admitted to dealing on, or has its price quoted on (or at least under the rules of) a regulated market.[1116].

1109 Hannigan op cit nat 97.

1110 See s 60(3)(b).

1111 For the complete list see CJA 1993 Part V Sched 2 or see Hannigan op cit at 95 et seq.; see also Gore-Browne op cit at 12.028 et seq.

1112 Wotherspoon op cit at 427.

1113 Wotherspoon op cit at 427.

1114 Hannigan op cit at 97.

1115 Sec. 54(1)(b).

1116 Artt 5-8 of the aforementioned Order; on the Regulated Market Order in general see Alcock, 'Insider dealing', 16 Comp Lawy 1995 at 21.

d) Dealing on a 'regulated market' or 'relying on or acting as a professional intermediary'

The final requirement which must be satisfied is that the acquisition or disposal occurs on a regulated market, or that the person who deals relies on a professional intermediary, or is himself acting as a professional intermediary.[1117] For the dealing to be prohibited it must occur on one of the 'regulated markets'[1118], and must be effected by a market maker or a stockbroker.

A 'regulated market' means any market, however operated, which, by an order made by the Treasury, is identified (whether by name or by reference to criteria prescribed in the order) as a regulated market for the purposes of Part V of the CJA 1993.[1119] The International Stock Exchange, the London Securities and Derivatives Exchange (OMLX) and the International Financial Futures Exchange (LIFFE) are currently recognised as regulated markets.[1120]

A professional intermediary is a person who carries on a business (not only incidentally to some other activity or because he occasionally conducts such activities)[1121] consisting of an activity mentioned in subsection (2): ie acquiring or disposing of securities whether as principal or agent, or acting as an intermediary between persons taking part in any dealing in securities[1122]. He either holds himself out to the public as willing to engage in any such business,[1123] or is employed by such a person[1124]. In order to prove that a person who dealt relied on a professional intermediary, it is necessary to establish that the professional intermediary carried out the activities in relation to that dealing.[1125]

A transaction also falls within the ambit of the prohibition when it involves

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1117 Sec. 52(3).

1118 Hannigan op cit at 99.

1119 Sec. 60(1).

1120 Wotherspoon op cit at 432.

1121 Sec. 59(3)(a) and (b).

1122 Sec. 59(2)(a) and (b).

1123 Sec. 59(1)(a).

1124 Sec. 59(1)(b).

1125 Sec. 59(4);see also Hannigan op cit at 100.

a dealing by a professional intermediary.[1126] This means that, when a professional intermediary deals with another professional intermediary (or with a private client) in an off-market face-to-face transaction (and, of course, this transaction being based on inside information), the transaction is within the scope of the 'dealing' prohibition.[1127] Thus a dealing through which a securities house purchases a large stake in a company from a particular shareholder, is within this definition. There may, however, be a defence available under the market information defence[1128] (see below sub 'defences').

It is interesting to note that this provision also seems to cover situations where a professional intermediary acts as an intermediary between two private clients who deal off-market.[1129] This is astonishing, for the intention of the Directive is to enhance confidence in the securities markets. The scope of the Directive is therefore limited to dealings on exchange markets, irrespective of whether professional intermediaries are involved. As a result of this requirement (ie that a professional intermediary needs to be involved) that the law covers OTC markets, which is particularly important in the derivatives area.[1130]

Only face-to-face transactions between private clients are excluded, because the Government maintained the view that it was up to the investors to protect themselves by seeking such information as they regarded to be necessary from each other.[1131] This is a sensible approach which accurately reflects the intentions of the Directive. It also shows that it is indeed not correct to penalise private deals effected through an intermediary; and it also suggests that the inclusion of face-to-face dealings in the German insider prohibition is more than questionable.

1126 Sec. 52(3).

1127 Hannigan op cit at 100.

1128 Hannigan, idem at 100.

1129 See Hannigan, idem at 100.

1130 Hannigan, idem at 100.

1131 DTI Consultative Document op cit para 2.11.

3. The encouragement offence

The second offence provided for by the CJA 1993 is that of encouraging another person to deal. A person who has information as an insider is guilty of insider 'dealing' if he encourages another person to deal in securities that are (whether or not that other person knows it) price-affected securities in relation to the information, whilst knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3)[1132].

These circumstances are the same as for the dealing offence, namely that the trade occurs on a regulated market or through a professional intermediary.[1133] The CJA (like the CSA) does not cover situations where the insider encourages another person not to deal, but to hold the shares (in view of positive information to be announced) or not to buy (where negative information is soon expected to be released).

It is not necessary for the person who has inside information to impart it to the person he encourages. Nor is it necessary that the other person should know that the securities he is encouraged to buy are price-affected securities.[1134] Nor that the recipient actually heeded the advice given by buying or selling the relevant securities.[1135] The actus reus of the offence is the imparting of advice to deal.[1136]

Unlike the German definition of insider trading the English formulation is broad enough to encompass classic tip situations like 'sell company A' as an insider offence[1137]. Under the old legislation the scope of the offence of 'counselling and procuring' was relatively clear.

'Encouraging has no such pedigree, and, while clearly being wider than counselling and procuring, it remains to be seen how the courts will construe it.'[1138] It may, for instance, suffice when a director at a brokers'

1132 Sec. 52(2)(a).

1133 Sec. 52(3).

1134 Rider and Ashe op cit at 51.

1135 Wotherspoon op cit at 429

1136 Wotherspoon, idem at 429.

1137 Rider and Ashe op cit at 51.

1138 Hannigan op cit (1st ed) at 101.

lunch gives an enthusiastic presentation which subsequently results in the brokers dealing.[1139]

4. The disclosure offence

The final prohibition relates to 'disclosing' the inside information. A person who has information as an insider is also guilty of insider 'dealing' if he discloses it, other than in the proper performance of the functions of his employment, office or profession, to another person.[1140] Disclosure is made in the proper performance of a person's functions, when it is directed at regulatory authorities or the company's bankers or brokers.[1141]

Under the old law it was necessary to establish that the person communicating the knowledge had reasonable cause to believe that the recipient would make use of the information for the purpose of dealing.[1142] It is now, at least in theory, easier to establish that an offence has taken place. However, the defendant may still avail himself of the defence provided by the new legislation, namely that he did not at the time of disclosing expect any person to deal in securities. This element is, clearly, retained from the old legislation. The difference is that it is now up the defendant to establish on the balance of probabilities[1143] that he did not expect the other person to deal.[1144]

On principle, the disclosure offence can be committed whether or not the recipient deals.[1145] This is in accord with the market protection approach chosen by the Directive. The insider cannot foresee whether the recipient will deal or pass on the information to others. Thus the source-insider who imparts his knowledge creates potential dangers to the market.

1139 Hannigan, idem at 102.

1140 Sec. 52(2)(b).

1141 Hannigan idem at 102.

1142 See Hannigan, idem.

1143 For the burden of proof see R v Cross [1990] BCC 237, [1991] BCLC at 125.

1144 Hannigan, idem at 103.

1145 Hannigan, idem at 102.

II. Defences

The English law provides defences for the accused insider. Even if a person meets all of the requirements outlined above and is thus apparently within the scope of the prohibitions, he may nevertheless escape conviction because a defence permits his conduct which is otherwise prohibited. The accused has, however, the burden both of raising a defence and establishing it.[1146]

The English law provides several defences, either general or special ones. In accordance with the preamble to the Directive, a person who acts on behalf of a public sector body in pursuit of monetary policies with respect to exchange rates or the management of public debt or foreign exchange reserves is exempted.[1147] This does certainly not apply to private dealings.[1148] It is submitted, however, that actions on behalf of a public sector body are as such potential inside information. Thus, persons who deal while they are in possession of such information, eg that the National Reserve Bank will lower the general interst rates (NB: this is market information), fall within the scope of the insider trading offence.

1. 'General' defences

General statutory defences are provided for each offence.[1149] They succeed if they are proved by the defendant on the balance of probabilities.[1150] The burden is on the accused to raise a statutory defence.[1151]

a) No profit expected

In respect of the dealing[1152] and the encouragement offences[1153], a person is not guilty if he shows that he did not, at the time, expect the dealing to

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1146 Gore-Browne op cit at 12.045.

1147 Sec. 63 of the CJA 1993. This is not a 'defence', but rather an exemption, cf Hannigan at 114 because the person (eg a public servant) would not have to raise it as a defence, but instead, as the law puts it, 'the prohibitions do not apply'.

1148 Hannigan, idem at 114.

1149 Sec. 53(1), (2), (3).

1150 Rider and Ashe op cit at 54.

1151 See R v Cross [1991] BCLC 15, which is a case dealt with under the old CSA 1985.

1152 Sec. 53(1)(a).

result in a profit or to avoid a loss[1154] which could be attributed to the fact that the information was price-sensitive.

The paucity of prosecutions under the previous legislation has left the ambit of this defence unclear.[1155] For instance, does it cover a person who traded to meet an unexpected tax demand, if he timed his transaction to make the maximum gain from the inside information in his possession?[1156] Prentice[1157] commenting on the former law, pointed out that the burden of proof on the person in such cases should prevent the defence from 'becoming a convenient escape for the unscrupulous'. The wording of the defence in view of the encouragement offence is not sufficiently broad to cover situations where the encouragement does not result in a transaction. Thus, if the bargain remains executory, the defence is inapplicable.[1158] However, prosecutions will be rare if completion has not taken place.[1159]

b) <u>Not 'on the basis' of the information</u>

It is a defence defence to both the dealing offence[1160] and the encouragement offence[1161] for the accused to show that he would still have acted as he did, 'even if he had not possessed the information'.

To fall within the ambit of this defence, the accused must prove that he in any event either planned to deal or to encourage someone else to deal. It seems that an insider is entitled to this defence if he acquires inside information within the course of a transaction and nonetheless completes it.[1162] But apart from situations where the accused can prove that he was under financial pressure[1163] to sell, it will be difficult for him to prove that the information had no influence on the decision to deal. Here again the

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1153 Sec. 53(2)(a).

1154 In s 53(6) it is expressly provided that, in the context of the defences, a profit will also include the avoidance of a loss.

1155 Wotherspoon op cit at 430.

1156 Wotherspoon, idem at 430.

1157 'The Companies Act 1980', op cit at 131.

1158 Gore-Browne op cit at 12.045.

1159 Rider and Ashe op cit at 54. The present author shares this expectation.

1160 Sec. 53(1)(c).

1161 Sec. 53(2)(c).

1162 Gore-Browne op cit at 12.046.

timing of the deal will be important.[1164]

Gore-Browne[1165] suggests that this defence might also be available to a trustee who comes into possession of inside information and finds himself impaled on the horns of a dilemma: if he deals, he is commiting an offence, and, if he does not, he might well be considered to be in breach of trust or even negligent. But it is doubtful whether this defence covers such situations at all, where the trustee is in a dilemma between the insider dealing prohibition and his obligations under the common law as a trustee or agent. The actual problem in these situations is one of conflict of interest; and this is certainly not addressed in the vaguely formulated defence to insider traders. A defence as such is of minor importance, and therefore its intention would not seem to be to regulate the important issue of conflicts of interest. Moreover, we do not know whether these defences, which were not mentioned in the Directive, are in accord with the European law. If they are not, they would not even be applicable. It is submitted that the above trustee situation is not covered by the defence that the insider would have acted the same way even without possession of the inside information.

c) Information 'assumedly disclosed widely enough'

A person will not be held liable for dealing or encouraging if he can show that at the time of the alleged offence he believed on reasonable grounds that the information had been or would be disclosed widely enough to ensure that none of the other parties to the transaction would be prejudiced because they did not have the respective information.[1166]

This 'closed circle'[1167] defence appears to have been introduced to meet the merchants banks´ and other financial institutions´ concerns about the impact of the off-market dealing offence on corporate finance transactions. This

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1163 See Gore-Browne, idem at 12.046.

1164 Rider and Ashe op cit at 54.

1165 Op cit at 12.046.

1166 Sec. 53(1)(b) for the dealing and s 53(2(b) for the encouraging offence - with the slight difference being that the defendant must show that he believed that the information had been or would have been, *by the time of the deal* which he was encouraging, widely enough disclosed to ensure that no-one would be prejudiced.

1167 See Wotherspoon op cit at 430.

defence has (no doubt rightly) been criticised.[1168] A suggested example is that two parties are in contact with each other who both have information that cannot yet be made public.[1169] This example is not convincing, because in that situation no defence is necessary at all. If, in such a situation, there is no exploitation of an informational imbalance there can also be no insider trading. And vice versa, if the deal takes place to the advantage of both parties (eg front-running ahead of a forthcoming publication of the information), it would seem to be a clear case of insider dealing irrespective of whether or not the parties assume the information is disclosed widely enough.

In fact, there seems to be no conceivable example of this defence. It is submitted that this special defence is a rather unhappy one. The provision reveals with great clarity that the present English legislation is not really intended to serve the interests of the market (let alone the interests of small investors). The law purports to be in the public interest, but in truth it enhances the interests of a particular group of people, namely those who work in these markets as financial experts or analysts. It is therefore unlikely that the law will produce positive effects. In terms of the 'democratic approach' suggested above[1170] such legislation does not reflect a majority opinion amongst people interested in capital markets.

d) Defences to the offence of disclosing information

The provision that provides defences to the offence of disclosing information is slightly different from the one that relates to the dealing offence. A person is not guilty of insider dealing by disclosure if he shows that he did not expect any person, because of the disclosure, to deal in securities in the circumstances of s 52(3) (ie insider dealing on a regulated market or through an intermediary);[1171] or that, although he had such an expectation at the time, he did not expect the dealing to result in a profit attributable to the fact that the information was price-sensitive.[1172]

This is presumably meant to mitigate the breadth of the disclosure offence

1168 Wotherspoon, idem at 430.

1169 Rider and Ashe op cit at 55.

1170 See above, last chapter of Part I.

1171 Sec. 53(3)(a).

1172 Sec. 53(3)(b).

which disclosing the information accidentally, or even casually in a social setting.[1173] A defence is available if the insider did 'not expect the other person to deal' (ie the person who received the information accidentally). Nevertheless, this other person may be liable as a tipee.[1174] The defence need not reach any further, because disclosure in the proper performance of one´s employment is exempted.[1175]

2. Special defences

In addition to the above general defences, the law provides three special defences set out in Sched 1 to the Act which can be described as 'market defences'[1176]. The Treasury is empowered to amend Sched 1 by statutory instrument.[1177] The special defences only relate to the dealing and encouragement offences.[1178]

a) Market maker

A person is not guilty of insider dealing by virtue of dealing in securities or encouraging another person to deal if he can show that he acted in good faith in the course of[1179] (i) his business as a market maker,[1180] or (ii) his emplyoment in the business of a market maker[1181]. The Schedule can be amended in future to allow for the evolution of market practices. These defences will probably be used by City professionals when accused of insider dealing. However, they have not been relevant in most insider dealing cases which have been prosecuted to date.[1182]

A market maker is a person who holds himself out at all normal times in compliance with the rules of a regulated market or an approved

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1173 Hannigan op cit at 116.

1174 Hannigan, idem at 116.

1175 Rider and Ashe op cit at 55.

1176 Rider and Ashe, idem at 56.

1177 Sec. 53(5).

1178 Wotherspoon op cit at 431.

1179 Sched 1, para (1), (1).

1180 Sched 1, para (1), (1)(a).

1181 Sched 1, para (1), (1)(b).

1182 Hannigan op cit at 109 et seq.

organisation (ie an international securities self-regulating organisation approved under para 25B of Sched 1 to the FSA 1986),[1183] as willing to acquire or dispose of securities[1184] and is recognised as doing so under those rules[1185]. Any private dealing by such a professional while in possession of sensitive information is prohibited.[1186]

The intention of the law is clear. Market makers are, by definition, obliged to set prices at all times. Without a proper defence, their frequent possession of inside information would render them unable to deal altogether. The market would become inefficient. The former law[1187] required that the information be acquired in the course of the market maker's business. This requirement has rightly been removed[1188] by the new legislation[1189].

b) The 'market information' defence

A person is also not guilty of insider dealing if he shows that: (i) the information which he had as an insider was 'market information';[1190] and (ii) it was reasonable for a person in his position to have acted as he did despite having that information as an insider at the time.[1191] The market information defence intends to cover a variety of 'City situations'. For example, the size of the rump on a rights issue is inside information, yet the underwriter has to place those securities. Without an exemption, any dealing or encouraging of others to deal would be criminalised.[1192] This defence is said to have come into existence because the Government bowed to pressure from City practitioners.[1193]

Market information is defined as information consisting of one or more of

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1183 Sched 1, para (3).

1184 Sched 1, para (2)(a).

1185 Sched 1, para (2)(b).

1186 Hannigan op cit at 110.

1187 Cf s 3(1)(d)(i) of the CSA 1985.

1188 See Wotherspoon op cit at 431.

1189 Following the preamble to the European Directive.

1190 Sched 1, para 2(1)(a).

1191 Sched 1, para 2(1)(b).

1192 See Hannigan op cit at 111.

1193 See Wotherspoon op cit at 431.

the following facts:[1194]

(1) that securities of a particular kind have been or are to be acquired or disposed of, or that their acquisition or disposal is under consideration or the subject of negotiation;

(2) that securities of a particular kind have not been or are not to be acquired or disposed of;

(3) the number of securities acquired or disposed of or to be acquired or disposed of, or whose acquisition or disposal is under consideration or the subject of negotiation;

(4) the price (or range of prices) at which securities have been or are to be acquired or disposed of or the price (or range of prices) at which securities whose acquisition or disposal is under consideration or the subject of negotiation may be acquired or disposed of;

(5) the identity of the persons involved or likely to be involved in any capacity in an acquisition or disposal.

In short, 'market information' means information about transactions and contemplated transactions in shares and the identity of the persons involved. A typical example of the envisaged market information was said, by the Economic Secretary to HM Treasury, to be when an individual sells a large block of shares,[1195] and when the publication of that information would have a material effect on the share price, as would the knowledge that someone intended to sell the block of shares.[1196]

It must be noted, however, that this type of market information concerns only the market in shares/options. It does neither refer to a group of

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1194 Sched 1, para 4 (a)-(e).

1195 It seems indispensable that we should clarify two things: firstly that in the case of such a sale there are actually two types of information, namely, the fact that shares are sold and the identity of the seller; secondly that when the 'individual' is not an individual but a moral person, for instance a company, the information that a block of shares is disposed of is not market information but company information because it relates to the assets of the company.

1196 Parliamentary Debates, HC, Standing Committee B, 15 Jun 1993, col 216.

enterprises nor to statistical data.[1197]

Also, it has to be decided in which situations 'it is reasonable for a person in his position to have acted as he did'. In determining this, the following must be to taken into account:

(i) the content of the information,
(ii) the circumstances in which the insider first had the information and in what capacity, and
(iii) the capacity in which the insider now acts.[1198]

A practitioner should be guided by the rules of the body which authorises him to conduct investment business or the rules of the market in which he is dealing.[1199] If, however, the courts accept the City practice as relevant for the interpretation of the law, then the City could openly dictate legal positions. The capital market is certainly an important feature in our society, but this is definitely not a desirable outcome.[1200]

There is yet another type of market information defence. A person is not guilty if he can show that he acted in connection with an acquisition or disposal which was under consideration or the subject of negotiation, with a view to facilitating the accomplishment of the acquisition or disposal, and that the information arose directly out of his involvement.[1201] This provision echoes, but in a different language, the defence provided by s 3(2) of the CSA 1985, which stated that an individual was not, by reason only of his having information relating to any particular transaction, prohibited from dealing if he did so in order to facilitate the completion or carrying out of the transaction.

The essence of this defence is to allow a bidder to buy shares in the target in advance of a bid, provided that the dealing is done to facilitate or complete the company's bid.[1202] This, again, is a defence which suits the interests of the City people. Also, it fosters the process of conglomerisation because it

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1197 See hereinbefore sub 'market information'.

1198 Sched 1, para 2(2) (a)-(c).

1199 HC Debates, Session 1992-93, Standing Committee B, 15 Jun 1993, col 217; cf Rider and Ashe op cit at 57.

1200 Hannigan op cit at 112; the present author shares this view.

1201 Sched 1, para 3.

1202 Hannigan op cit at 113.

facilitates take-overs and buy-outs.

c) Price stabilisation

The CSA 1985 provided an exemption for price stabilisation activities, which is now repeated in the CJA 1993, Sched 1, para 5. Stabilisation is a process whereby the market price of a security is pegged or fixed during the period in which a new issue of securities is sold to the public. The reason why stabilisation is permitted is that when a new issue is brought to the market, the sudden glut will sometimes force the price lower for a period of time before buyers are found for the securities on offer.[1203]

The procedure to be followed is laid down in SIB Core Rule 29. The effect is that the price is kept at a higher level than would otherwise be the case. A person is not guilty of insider dealing (or encouraging) if he shows that he acted in conformity with the price stabilisation rules[1204] made under s 48 of the FSA 1986. These rules require the identification of the period during which the stabilisation may occur, the imposition of limits on the price at which the manager may stabilise, and the keeping of records in regard to the stabilising transactions which were carried out.

The insider dealing aspect arises from the fact that the fund manager who deals in the securities (by buying back what had previously been sold) is dealing at a time when he has price-sensitive information, namely that the stabilisation is taking place and the circumstances which require that stabilisation.[1205]

1203 Hannigan, idem at 113.

1204 Sched 1, para 5.

1205 Hannigan op cit at 114.

III. Some evaluating remarks

1. Concerning the offences

With regard to the territorial scope of the insider trading provisions, no doubt Hannigan[1206] is correct when she says that, given the more or less equivalent insider prohibitions in the other Member States and also the non-EU States within the European Economic Ares, the provisions should provide an effective framework of legislation against insider dealing throughout Europe.

The fact that it need not be shown that the insider dealt because of his inside knowledge will help facilitate prosecutions. This is different from most other legislation on insider dealing, for instance, the South African provisions. However, the motivation of the insider trader must be considered where the accused raises the defence provided in s 53(1)(a) of the CJA 1993, ie that he did not expect the dealing to result in a profit. It is then up to the insider to prove that he acted without having the expectation to make a profit. This may indeed facilitate the prosecution.

It is not desirable that insider 'dealing' now covers situations where an agent who acts on instructions (for example a bank carrying out the order by its customer) merely carries out the instructions. In order to comply with the insider dealing prohibition, the bank has to refuse to carry out the order. No doubt the customer will ask why; hence the bank would have to disclose the information in the proper performance of its professional duties, or at least mention that there is price sensitive information. Such situations occur frequently. The law should therefore clarify that acting as an agent on a principal/agent basis is exempted from the insider dealing prohibition, so long as the agent does not use the inside information.

The term 'regulated market' is not well defined. The definition merely provides that a regulated market is identified as such by the Treasury. It is apparent that all official stock markets are within the definition, whether they take place on a floor or through computer transactions.

The extension of the dealing offence to OTC markets and even to private clients´ deals where an intermediary is involved, makes the offence far too

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1206 Idem, at 104.

wide. The scope of the prohibition is extended in such a way that it is no longer reconcilable with the Directive. In its preamble it is laid down that the intention is to protect secondary markets in securities without modifying the existing national law on contractual duties, for instance, the duty to disclose information. More generally, the situation of face-to-face dealings, whether inside information is used or not, should give rise only to civil liability, and not to criminal sanctions. In private deals the confidence of investors in any public good (eg security and reliability of capital markets) is not at stake. There is therefore no good reason for such a criminalisation.

2. Concerning the defences

a) The general defences

The English law provides very detailed general defences. It is questionable whether all this was necessary. For instance, the general defences available where the defendant 'would have dealt in any event' or where he 'thought be 'inside'?) seem to have been designed for the protection needs of the financial services people, and do not meet the core of the insider matter. They make it readily apparent that some of the crucial definitions were not moulded in an appropriate fashion. For instance, if the insider would have dealt in any event, he obviously did not have mens rea with regard to the offence of insider trading at the moment he first had the intention to deal; and the law regards this moment as decisive, not the mere fact that the insider had inside information at some later stage.

Where the information is 'inside', what purpose does this defence (ie the insider thought the information was already widely enough disclosed) pursue? Either the insider *erred* about the the fact that the information was already public when he dealt (in which case he simply lacks mens rea with regard to *exploiting* an informational advantage) or he simply pretends that he thought that the information was already widely enough spread, in which case there is no room for a defence.

If the law had taken into account the economics of insider trading, it would rather have defined public as either 'published according to publishing rules' or as 'no longer profitable', both of which could be tested objectively. As it is, there is no point of reference as to when insiders can start trading again.

Another shortcoming of the legislation is that it does not address the issue of whether inside knowledge is imputed to the head department in a financial conglomerate, and to what extent it may then be used in favour of clients, for instance, in the retail department. It remains unclear whether the SIB-rules concerning Chinese Walls can possibly modify the obligations of agents under the common law.[1207] This is regrettable because such instruments can also be used in favour[1208] of the client.

b) Concerning the special defences

The 'stabilisation defence' legalises market rigging in the aftermath of an issue and the practice, therefore, had to be exempted from the market manipulation offence set out in s 47 of the FSA.[1209] Most people seem to assume that price stabilisation is a good thing. On a closer examination the arguments in favour of this price stabilisation are less certain than they appear at first sight. The main argument in favour of it is not obvious at all. Why is it important to keep prices artificially at a higher price by creating a demand which is not real in the sense that investors do not want to buy the shares, at least not at the higher price? The market always prices goods or shares correctly. If newly issued shares dilute a company's capital, then why is it unacceptable for the price of the shares to decline?

Besides, on the ground of the economic substitution hypothesis[1210] (ie that no matter in which shares one invests, one always gets the same value in the sense of risk and return mixture) it would seem that too much capital has to be used to keep the price artificially at a higher level. Why not rather use these funds in a more creative way? It is submitted that the better approach would be to reach price levels through supply and demand rather than through artificial and sometimes even manipulative devices whose benefits are more than questionable.

The market maker defence is a sensible one. Given that the economic arguments in favour of prohibiting insider trading are, at least in part, that the market maker's bid/ask-spread is widened because of expected losses to insiders, it is obvious that these market professionals, who are crucial to the functioning of the market, need to be protected.

1207 See McVea op cit at 242-246.

1208 See Tippach (Insider-Handelsverbot) at 250 et seq.

1209 Sec. 48(7) of the FSA and the FSA Stabilisation Order 1988 (SI No 717).

1210 See Part I of this study, see 'Market mechanisms'.

The defences of 'facilitating the accomplishment of an acquisition' and the 'market information defence' seem to overlap. Buying ahead of a take-over bid could be subsumed under both.[1211] The City people benefit from this defence because they certainly 'facilitate the accomplishment of an acquisition' when they buy shares of the target company. Yet the building up a block of shares ahead of a bid does not only occur because the completion of the bid is facilitated. Primarily it occurs because the bid has to be at a price higher than the current one,[1212] and therefore the buyer of the shares will make a good profit without much risk.

On the whole it appears that City activities are very well protected. However, the fact that the law relies on the 'reasonableness of the act' where the market information defence can be raised, introduces an element of uncertainty. The concept of reasonableness is not generally accepted and does not provide the certainty which the markets need.[1213] Who would be able to determine in advance what is 'reasonable', and hence give clear advice on which actions are prohibited? This situation is awkward for legal consultants and firms which plan capital market activities, eg a take-over.

1211 Hannigan op cit at 113; there is also the view that buying ahead of a take-over bid is not market information, but company information which concerns the future prospects of a company (such as synergy effects which are positive for future earnings), see Tippach op cit at 201 et seq.

1212 Davies, 'The Take-Over Bidder Exemption and the Policy of Disclosure', in: Hopt/Wymeersch (eds) op cit (European Insider Dealing), 243 at 248.

1213 Law Society Company Law Committee, 'The law on insider dealing', Dec 1992, Memorandum No 281, para 9.2.

D. Offences and defences under the German law

I. The offences

1. Direct (primary) insiders

As far as primary insiders are concerned, the German provisions are very similar to the English because they are both based on the Directive. Under the German provisions a primary insider is not allowed (i) to acquire or dispose of insider securities for his own account or the account of others, or on behalf of another by exploiting his knowledge of an insider fact.[1214] This formulation of the law is the same as the English 'dealing offence', and encompasses also dealing on the account of another person.

The insider is also prohibited (ii) from communicating or giving access to an insider fact without authorisation to another person.[1215] This is by and large the same as the 'disclosure offence' in the English law.

Also, the insider is not allowed (iii) to recommend on the basis of his knowledge of an insider fact the acquisition or disposial of insider securities to another person.[1216] This provision has the same scope as the 'encouragement offence' in the English law, but is more clear-cut.

The German word for 'recommend' does not have the same ambiguity as the word 'encourage'. The formulation covers situations where the insider merely mentions 'the good results of his company' without expressly recommending to buy the shares. But where the insider did not foresee that the recipient of the information would deal, an appropriate defence (which is available under the English provisions) seems to be missing. Yet the German law has no need for this particular defence. In such a case the courts would most probably decide that the insider lacked mens rea with regard to recommending, and can therefore not be considered guilty.

a) Insider securities (dt.: 'Insiderpapiere')

'Insider securities' are securities which are admitted for trading to a domestic stock exchange or are traded on the so-called free market (which

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1214 § 14(1) No 1 WpHG.

1215 § 14(1) No 2 WpHG.

is a less regulated section of the official stock market); or are admitted in another Member State of the European Community or another contracting state of the European Area Treaty to trading on a market within the meaning of § (engl.: section) 2 sub-paragraph 1 WpHG.[1217] § 2 WpHG contains a complete list of insider securities, encompassing shares and bonds, participating certificates, option certificates, derivatives traded on domestic or foreign markets, rights to subscribe to, acquire or dispose of securities, rights to payment of a margin arrived at by reference to a change in the price securities (ie contracts for difference) and other future contracts.[1218]

The issue whether the creation of a right is included in the term 'dealing', which has been directly addressed by the English Act[1219], is not properly dealt with by the WpHG. It is submitted that the 'creation of a right' is covered by the word 'dealing'. It does not make sense to include all the rights within the definition of 'securities', and then throw them out by the back door by narrowing down the meaning of 'dealing'. However, so long as the security is not admitted on a market there is notthing to 'deal' in.

Given the strictness of the principle of objective interpretation in German penal law, it would have been better to clarify this issue by adding the following sentence to § 14(1) No 1 and equally to § 14(2) WpHG: 'acquisition and disposition of securities include the creation of rights and the bringing to an end of contracts by which securities were created.' It is submitted that the law be reviewed in this respect.

b) By exploiting his knowledge[1220]

The element of 'exploiting the knowledge' contains one of the main problems for the prosecution. It means that the court must be satisfied as to the proof of the insider's subjective motivation. The defendant will certainly raise all those issues which under the English law are referred to as 'defences'. Yet the burden of proof under the German law is in favour of the accused because he does not have to prove anything, not even on the

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1216 § 14(1) No 3 WpHG.

1217 § 12(1) No 1 and 2 WpHG.

1218 § 12(2) No 1 to 4 WpHG.

1219 See s 55(2) and (3) of the CJA 1993.

1220 The German formulation is: 'unter Ausnutzung seiner Kenntnis'.

balance of probabilities. Thus, although the German insider legislation does not provide for defences as the English law does, the defendant is in a more advantageous position.

For instance, under the English law the insider would have to raise the defence that he did not expect the dealing to result in a profit. Under the German law the prosecutor will have to prove that the insider has exploited the information. For the same reason, the 'defence' that the insider 'thought the information had been disclosed widely enough', is also covered by the exploitation requirement. The prosecution must prove that the accused knew that the information was not yet made public.

The insider may argue that he erred about the element of 'non-public', or that he did not think that his knowledge was still exploitable[1221]. The same is true for the argument that he 'would have dealt in any event'. It will prove to be extremely difficult to establish that the insider indeed wanted to exploit the information, ie that he based the transactions on that particular piece of information. The courts should therefore take into account that someone can make his investment decision by means of information even if such information merely confirms facts already known to the insider[1222].

2. Tipees and sub-tipees

The prohibitions with regard to tipees are laid down in § 14(2) WpHG[1223] according to which it is forbiden for a third party '... to acquire or dispose of insider securities for his own account or on account of another or on behalf of another by exploiting such knowledge'.

Hence tipees are not prohibited from passing on the information, although the Directive, in its Article 6, opened up the possibility of extending the disclosure and encouragement offences to tipees.

1221 Cf the 'closed circles' defence in the English law.

1222 With regards to this suggestion see the approach of the Panel on Takeovers and Mergers in its Statement on Johnson&Firth Brown Ltd/Dunford& Elliot Ltd, 23 Dec 1976 at 5 referred to by Rider op cit at 831 fn 7. The Panel adopted a similar view in that decision.

1223 Based on Art 4 of the Diretive.

II. Defences

Apparently there are no defences available. Merely transactions effected by reason of monetary or currency policy or by reason of the administration of the public debt are exempted.[1224] Also, the disclosure offence is by definition[1225] limited to situations where the disclosure happens without authorisation.[1226]

As we have seen, the general requirements under the German penal and criminal procedural laws protect the insider at least as well as he may be protected under the English defences. If, for instance, it is 'reasonable for someone to carry out transactions', although he is in possession of market information (in the English law this is a defence), he would probably not have 'wanted to exploit' his knowledge and would therefore not meet the German requirement needed for conviction. The protection of financial services people in Germany and England appears to be much the same.

Yet some specific defences which are available under the English law, are missing. Firstly, the market maker defence, which is regrettable given his importance for the securities markets. It must be borne in mind though, that the trading system in Germany (the so-called 'auction system') differs somewhat from the English trading system on capital markets: there are no market makers, the system is exclusively based on official brokers. His official duties include the carrying out of a trade at his own risk so long as an order on the other side does not exist. This makes it necessary to provide him with a special defence.

Secondly, there is no defence that can facilitate the accomplishment of acquisitions, eg take-overs. The reason for this could be the fact that in Germany it is still not settled whether to regard take-overs in a positive or a negative light.[1227]

1224 § 20 WpHG.

1225 Cf Art 3(a) of the Directive.

1226 § 14(1) No 2.

1227 Mertens, 'Förderung von, Schutz vor, Zwang zu Übernahmeangeboten', AG 1990, 252 et seq.

III. Evaluating remarks

1. The offences

The most difficult problem for the prosecution is to show that the insider was 'exploiting his knowledge'. Unlike the English law, this requirement of the Directive was transposed into the German domestic law without taking into account the difficulties it creates for the prosecution. It is submitted that this element considerably reduces the effectiveness of the prohibitions.

Without any further assistance given to the prosecution it is likely that people who are skilled in financial matters will escape, for they are able to furnish reasons other than being in possession of the inside information for carrying out a transaction in the 'affected' security.

Passing on the information enlarges the potential dangers of the misuse of inside data on securities markets. If one wants to protect the functioning of these markets, tipees should be prohibited not only from 'dealing', but also from procuring and counselling. It was therefore suggested that the provision should be extended so as to include tipping by tipees[1228], as it was mentioned by Art 6 of the European Directive.

2. The defences

There are no particular defences under the German law on insider trading. The strict interpretational limitation to the objective wording of the prohibition, and the necessity for the prosecution to prove all the requisite elements (without any facilitation as provided, for instance, in the South African law), balance this out.

1228 See Crystal and Atherton, 'United Kingdom', in: Gaillard op cit, 171 at 211.

Chapter 5: Sanctions

We have examined the elements of inside information, and what the insider is prohibited to do once he is in possession of inside information. What remains to be considered is the question of which sanctions are appropriate.

A. Sanctions under the South African statutes

In South Africa, the present legislation has brought about some major changes to the previous systems of sanctions and remedies. Apart from increasing the maximum fines, a statutory civil remdy has been created. This follows the trend in other countries, such as the US, where the relevant authorities have shown a more concerned attitude to both the policing and the punishment of insider trading.[1229]

I. Criminal sanction

The penalty for insider trading is now a fine not exceeding R500.000 or imprisonment for a period not exceeding ten years or both such fine and such imprisonment.[1230]

Compared to the pre-existing penalty of a fine not exceeding R8.000 or imprisonment not exceeding a period of two years this seems to be dramatically stricter. Yet, considering the enormous rewards which can be gained from insider trading, it may appear doubtful whether the penalty is sufficiently heavy to provide the necessary deterrent.[1231] Botha[1232] points out that the placing of a ceiling on the amount of the fine might not be realistic if a fine is to serve as an effective deterrent. He suggests a harmonisation with the penalty provisions of the Income Tax Act which provide for additional 'penalty taxes'[1233]. Besides, one must bear in mind that courts hardly ever impose maximum fines.

1229 Botha, 'Increased maximum fine for insider trading: A realistic and effective deterrent?', (1990) 107 SALJ 504 at 504.

1230 Sec. 441(1)(a).

1231 Jooste op cit at 599.

1232 Botha op cit at 508.

1233 Botha, idem at 508.

Only the future will tell whether the obligation to furnish certain information to the Panel, in particular when a person becomes the beneficial owner of 10% of the equity security of quoted companies,[1234] is an effective means of detection; for one of the pricipal purposes of the disclosure appears to be to show the relationship in time of any dealings by those required to make disclosure to any particular public announcement of price-sensitive information.[1235]

II. Civil remedy

Given the traditional problems concerning civil liability for insider trading under the common law,[1236] the legislature considered it necessary, in order to create a civil remedy against insiders, to provide a statutory-based remedy. The new s 440F(1) of the Companies Act provides that any person who contravenes the criminal provisions is liable to any other person for any loss or damage suffered by that person as a result of such contravention.[1237]

A different question is whether or not the contract between investor and insider is void or voidable.[1238] Yet a contract which contravenes a statute

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1234 Sec. 440G.

1235 Jooste op cit at 599; Henochsberg op cit at 981.

1236 That is the interminable story of Percival v Wright, 2 CH 421; see Rider, 'Percival v Wright - per incuriam' (1977) 40 Modern Law Review at 471; see, however, for a completely different approach Yoran, 'Insider trading in Israel and England', Jerusalem, 1972 at 23 et seq., who is of the opinion that a court would have ample grounds to distinguish on the facts because the shareholders did not suffer any damages in Percival v Wright. The present writer is of the opinion that civil remedies are inappropriate because, economically, the insider does not harm other investors. Nevertheless, Yoran's view is probably correct because in Percival v Wright the transactions were not carried out on impersonal stock markets. In South Africa, however, they still stick to a very conservative interpretation of the Percival decision. For instance, the view that a director has a direct fiduciary relationship with the shareholders is expressed by Engelbrecht, 'Towards a basis of liability for insider directors in South Africa', Master dissertation UCT, 1994 at 39 et seq.

1237 Sec. 440F(4)(a).

1238 See for this subpoint Botha, 'The legal status of an insider-dealing contract', (1992) 4 SA Merc LJ 83.

will not be declared void unless such was the intention of the legislature. Voidability is the rule in the case of a contract in violation of a statute which imposes a criminal sanction.[1239] It would seem that the main intention of the law is to reduce the frequency of insider trading, and not to render void contracts which involve insider dealing. Thus the better view is that contracts on the stock exchange are not unenforceable by reason only of the criminal offence.[1240]

Sec. 440F(a) of the Companies Act (ie the prohibition of insider trading), applies to both dealings on Stock Exchanges and private dealings. The reason for this is that s 440F(4)(b) runs '*in case* of dealings in a security on a stock exchange or a financial market ...'. This means that subsection (a) does necessarily include both types of dealings. This dissertation is exclusively about dealings on Stock Exchanges and we shall therefore not consider private dealings.

The civil remedy may cause great difficulties. Firstly, one must establish a link of causality[1241] between the insider transaction and the damage suffered. Secondly, it has to be considered what actually constitutes the damage.[1242] These problems have been dealt with at length in Part I, so that a brief description of the main problems is sufficient here.

Economic research suggests that the price shift caused by individual insider trading is practically zero, because the demand curve for any given stock is likely to be perfectly elastic over a very wide range. The damage can therefore not have been caused by the insider, but must have been caused by something else. Economic research suggests that the price shift happens due to certain signals on stock markets (ie signals that insiders are present).

Take, for example, the dealer who would not have sold his option had he known that positive information was about to be released by the company. The only thing that would have prevented him from dealing would have been disclosure either to him personally, or to the public in general. The

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1239 Metro Western Cape (Pty) Ltd v Ross 1986 (3) SA 181 (A) at 188 F-H per Boshoff JA.

1240 Botha op cit (1992 Merc LJ) at 86 et seq., quoting Knox J in Chase Manhatten Equities Ltd v Goodman & others, the reference being [1991] BCLC 897 at 933.

1241 See for instance Jooste op cit at 603.

1242 See above, Part I.

wrongful act that causes the damage is keeping silence, not, however, insider trading. Hence it must be established that the insider was under a duty to disclose - and that will lead us exactly to where we were under Percival v Wright, ie the necessity to establish such a duty which simply does not exist in anonymous dealings on exchange floors.

Taking into account the economic finding[1243] that, on impersonal markets, the gain of the insider does not reflect the loss of the outsider, the civil remedy is altogether inappropriate. It is submitted that the statutory civil remedy newly created by the South African law is a paper tiger.[1244]

Also, what would really be left to be found out in a civil law suit which has not previously been found in a criminal proceeding? The civil aspect of the whole issue is in fact a minor one. Nevertheless, the view that civil sanctions should be imposed is expressed quite frequently.[1245]

There is a certain 'argument' (it is submitted that this is a vague feeling rather than a substantial argument) which is truly at the base of the 'wish' to create a civil remedy. Jooste[1246] has put this rather emotional approach into words: it 'seems undeniable' that if insider dealing on an exchange market is made a criminal offence, it is also 'wrongful' at civil law.

But is this the correct premise? It is argued that there is no logical necessity to regard something as wrongful at civil law simply because the same act is a criminal offence. The exchange floor is a public space where everybody offers or demands securities rather than a place where a number of individual dealings are carried out. Investors in this public space want a correct pricing[1247] under rules which protect a public good[1248] ie the

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1243 See hereinbefore Part I.

1244 See The King Task Group Report op cit at 16, 20, 31 and p 5 of their proposed Insider Trading Act. The Report suggests that the legislation should provide far more civil remedies; see also Van Zyl, 'South Africa, Insider trading regulation and enforcement', 15 Comp Lawy 1994, 92 at 96.

1245 See, for instance, Naylor op cit (The use of criminal sanctions) at 90; see also McVea op cit (Bus Law); see also King Report op cit.

1246 Op cit at 602.

1247 Schiereck and Weber, 'Parkett, IBIS oder London - Die Präferenzen institutioneller Investoren', 11/96 Die Bank 654, state that fair pricing is one of the most important criteria for institutional investors when they decide in which country, and on which functioning of that market. Individual dealings do not really occur because, in most cases, offer and demand do not match, for example someone offers 2.000 shares and 'finds' 100 persons each of them buying 20 of the shares. They would not meet in a face-to-face situation, but only in a public space like the stock exchange. It is obvious that this public space is protected by the criminal sanction. The Directive, for instance, assumes that the functioning of the market depends on investors´ confidence. The underlying concept is that people invest because they feel safer in a public space without insiders. This safety is guaranteed by the criminal sanctions. If our hypothesis ie that insider trading is economically neutral is true, there is no need to create any kind of civil liability for insiders. At least there would not be no reason to think that one must regard insider trading as a wrongful act at civil law, too.

B. No sanctions provided in the European Directive

There are no specific remedies provided in the Directive. This question was open to the Member States. The Directive merely says in Art 13:

> 'Each member state shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive. The penalties shall be sufficient to promte compliance with those measures.'

We shall now consider the sanctions provided by the two Member States whose insider laws have been discussed. The English legislation provides rather draconian sanctions.

Stock Market, they are going to invest (others are: comfort offered by the trading system, fast and cheap carrying out of their orders).

1248 This view is supported by the US Supreme Court in Basic, Inc v Levinson, 485 US 224 (1988) holding that 'an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price'. See also Khama op cit (corporate criminal liability) at 1520 who, correctly, says that public enforcement is preferable when victims are not identifiable - which is the case with insider trading.

C. England

The only sanction provided by the Criminal Justice Act 1993 is a criminal one. Despite calls for a change in 1990, the Government announced that it intended to retain the criminal law as the primary tool of enforcement against insider dealing and this is reflected in the present legislation.[1249]

Any individual guilty of insider dealing shall be liable

(i) on summary conviction, to a fine not exceeding the statutory maximum or imprisonment for a term not exceeding six months or to both;[1250] or

(ii) on conviction on indictment, to a fine or imprisonment for a term not exceeding seven years or to both.[1251]

The maximum jail sentence had already been raised from two years to seven in 1988 by s 48 of the Criminal Justice Act 1988. The same statutory maximum fine is provided by s 61(1)(b) of the CJA 1993. Yet, since 1980 only one convicted insider has gone to jail (and then only for a period of nine months).[1252] The impact of that amendment seems limited because, without application, the deterrent effect of a sanction remains vague.

There is no civil remedy. No contract is void or unenforceable by reason only of s 52 of the CJA 1993 (ie the offence of insider trading).[1253] Civil liability may, however, be possible under s 62 of the FSA 1986 for breach of SIB´s conduct of business rules.[1254]

1249 Hannigan op cit at 117; for an instructive comparison with the US securities laws see Fishman, 'A comparison of enforcement of securities law violations in the UK and US', 14 Comp Lawy 1993 at 163.

1250 Sec. 61(1)(a).

1251 Sec. 61(1)(b).

1252 Hannigan op cit at 117.

1253 Sec. 63(2). This was not quite the position under the old Act, cf s 8(3) of the CSA 1985 in which was provided that 'no transaction is void or voidable by reason only that it was entered into in contravention of s 1, 2, 4 or 5 (ie insider dealing)'. Knox J found that s 8(3) meant to prevent the disruption of completed Stock Exchange transactions, cf [1991] BCLC 897. Where this was not the case the contract was considered unenforceable because there had been a case of insider trading.

1254 For the implications of s 62 see Poser op cit (International securities regulation) at 293 et seq.; see also MacNeil, 'FSA 1986: Does s 62 provide an effective remedy for breaches of Conduct of Business Rules?', 15 Comp Lawy 1994 at 172.

D. Germany

The German legislation also opted for criminal sanctions which are provided in § 38 WpHG:

Any person who

1. acquires or disposes of an insider security contrary to the statutory prohibition under § 14 sub-paragraph 1 No 1 (ie insider dealing) or sub-paragraph 2 (ie tipee dealing),

2. passes on or makes available an insider fact contrary to § 14 sub-paragraph 1 No 2 (ie communicating the information), or

3. recommends the acquisition or disposal of an insider security contrary to § 14 sub-parragraph 1 No 3 (ie recommending on the basis of inside information)

is liable to imprisonment of up to five years or a fine.

The law further provides that 'the above shall include any act contrary to an equivalent prohibition abroad'.[1255] This means that an act committed by an insider, which contravenes an insider trading prohibition of another European country, falls under the German sanction. For instance, insider dealing committed by a German resident on a foreign Stock Exchange (eg Paris Stock floor) is contrary to the German law - irrespective of whether the French authorities pursue the case or not.

It does not seem possible to impose both a jail sentence and a fine upon the convicted. It is, however, possible to strip the insider of all his profits;[1256] if he is sentenced to jail, he will certainly not keep his profit. The system seems to work quite efficiently now. The first two 'Strafbefehle' (ie penal order, a special procedure without trial under the German Penal law) imposed fines of DM 540.000,-[1257] and DM 600.000,-[1258]. This should help create sufficient deterrent effect[1259]. In 1996 the Bundesaufsichtsamt dealt

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1255 § 38(2) WpHG.

1256 §§ 73-75 StGB.

1257 See FAZ Nr. 280, 1.12.1995 at p 32.

1258 Against Harald Kronseder (member of the family who owns Krones AG), see FAZ Nr. 192, 19.8.1995 'Erste Geldbuße wegen Insiderhandels'.

1259 Until 13th October there were already 15 insider cases, see FAZ Nr. 239, 14.10.1995 at p 23. Altogether some 44 cases have been dealt with until 5th June with 59 insider cases, four of which resulted in a conviction.[1260]

However, under the present German Penal law it would seem impossible to impose an order on the convicted individual, for instance a manager or director, which disqualifies him from the execution of certain professional tasks for a period of time. In order to impose such a disqualification order it would be necessary for the convicted director to have used his position so as to pursue goals which are contrary to his professional duties while he was executing such duties. In other words the indictable offence must be a result of the fulfilment of the tasks.[1261]
Trading on insider information is, however, not typical of professional tasks because tipees and subtipees who are not inside a company can deal on it as well.[1262] Yet, as the English case law has revealed, such disqualification orders can constitute very effective deterrents. It would therefore seem advisable for the German legislator to provide for such a 'side'-sanction, once the insider has been convicted.

It is also an issue of interest whether or not the prohibitions laid on insider dealing give rise to civil remedies provided by the general civil law.[1263] Civil sanctions are in fact not to be imposed on the insider under the German law, because the insider does not cause harm to other investors.[1264]

A further question is whether or not a contract not entered into on a stock exchange would be void or voidable because one of the parties to the contract was in possession of inside information. This problem is caused by the fact that the WpHG apparently applies to face-to-face dealings as well as to dealings on stock markets. This extension is surely not in accordance with the European Directive which, in its preamble, says that the intention of the European legislation is to protect the functioning of the secondary markets. However, § 1 WpHG says that 'this Act shall apply to trading in

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1996, see 'Die Welt' 5.6.1996 at p 13.

1260 See the article 'Prächtige Auftragslage bei der Untersuchung von Insiderhandel', FAZ Nr. 82, 9.4.1997 at p 25.

1261 RG St 68, 97; BGH St 22, 144; BGH Beschluß of 12 Sep 1994 - 5 StR 487/94 (LG Limburg), NStZ 1995 at 124.

1262 The question whether the latter is an appropriate sanction or not, as well as the problem of which period such a disqualification order should not exceed will be dealt with further on.

1263 Assmann op cit at 525 thinks that this is the case.

1264 Tippach op cit at 47 et seq.

securities and derivatives, both on and off the stock exchange ....'.

It is submitted that this extension is not only contrary to the intention of the Directive, but is also not reconcilable with the differences between face-to-face dealings and dealings on impersonal markets. It is also submitted that section 1 of the WpHG should be amended so as to exclude face-to-face situations from the insider trading prohibitions.

Part III: Towards a Model Code

Having examined both the economic implications of insider dealing and the legal solutions offered by three different laws, we shall now consider how to incorporate our findings in a legal model. The aim is to suggest what a Model Code of insider trading should take into consideration. To this effect both legal and economic findings need to be taken into account.

Chapter 1: Economic findings and a Model Code

Before one can start to formulate legal provisions it is essential to clarify the economic hypotheses upon which a Model Code is based. This helps define both the legal concept and the actual provisions.

A. Incorporating economic findings

First of all, we must ask ourselves how economic findings can be incorporated in a Model Code. As we have seen, there are persistent doubts as to whether insider dealing should actually be regulated ie prohibited and, if so, whether regulation should be based on a statutory criminal sanction. All modern economic approaches accept that the investor does not suffer much losses due to insider trading. The individual investor does not need extensive legal protection. Attention focuses therefore on the attempt to maximise social welfare through regulation. This aim is manyfold, and amongst its most significant components are the protection of allocational functions of the market and the enhancement of price efficiency.

I. Overall economic findings: uncertainty prevails

The most important economic finding is that there is no evidence that insider trading is in any respect economically harmful. None of the examined theories came to the conclusion that insider trading as such is economically detrimental to individual investors or to the performance of markets. On the contrary, some of the theories explicitly stated that insider trading is beneficial for both shareholders and markets.

Economic theory suggested, too, that the strict prohibitions imposed on insiders are the result of the influence of certain interest groups eg the financial services industry. This finding was confirmed by our examination of some existing laws, particularly the English law on insider trading.

Altogether, the provisions discussed lacked a coherent approach to the issue of economic theory. The theoretical models that the provisions are based upon remain very vague. Yet, as we have seen, a Model Code ought to be based on certain economic assumptions. The clarification reached by this preliminary work will facilitate the application of the law. It will also facilitate the task of revising its provisions, once economic research has yielded more convincing theoretical models.

Taking the economic doubts into consideration one is forced to think that de-regulation rather than regulation is inevitably a better solution to the problem of insider trading. One economic approach that has been dealt with in this examination is based on the premise that the parties involved (ie manager insiders and outsider shareholders) should be given the option of solving the problem on a contractual basis within the company, rather than relying on statutory provisions. The idea behind this suggestion is derived from the agency debate in economic literature. Its underlying assumption is that, despite certain differences between juristic and economic terminologies, managers are the agents of the shareholders.

A contractual solution may provide managers with further incentives to produce valuable information, and thus indirectly enhance the benefits of the shareholder principals. This model suggests that companies should be given the option to 'opt out' of the regulation. In doing so it reflectis a much more pluralistic, 'democratic' approach towards insider trading.

1. Contracts between managers and shareholders

Contracts between managers and owners of a company (within the articles of the company) could permit insiders to trade on inside knowledge if both information and trading are closely related to their management tasks. In exchange, managers would have to accept reductions in salary. These reductions would, of course, have to be in line with the expected insider trading profits. In order to provide the manager with some security, it may be necessary to cut the salary less than by the expected gains. In the case of opting out, the company's shares would no longer be monitored. Because the company will not have to pay for monitoring, transaction costs will be reduced, and hence the company's (ie shareholders') profit be increased.

Some doubts have been raised about to the feasibility of such contracts.[1265] What would happen, for instance, if the insider cannot make up for the reduction in salary, because the information did not yield as much profit on the market as the parties had expected (so-called 'ex-post settling-problem').

But the same kind of problem is present in other situations, too. Take, for example, agreements about additional rewards for a good performance by a company, or bonus stocks agreed upon in case the share price stays above a pre-fixed limit. By their very nature these contracts have to be re-negotiated every now and then, at least on the premise of an implied clausula rebus sic stantibus. One can therefore assume that managers and companies are able to solve the this problem in the insider trading context. It is submitted that all these difficulties are minor and can therefore be left to the parties involved.

2. Agency contracts and financial markets

The economic uncertainty about insider trading requires a flexible legal approach. At this stage, markets lack experience of how these contractual solutions work. Such a system should therefore not be 'prescribed' all of a sudden and in one go, but has to be introduced with care during a transition process. A proper democratic approach should therefore provide a regulatory system, and at the same time allow firms to opt out should they prefer the contractual solution. During the transition process more empirical data will be gathered and one would get the necessary feedback from all parties concerned: shareholders, firms, managers, brokers, market makers, small investors, banks, and financial consultants. Thus, at the moment, a Model Code should offer a choice between regulation and deregulation, rather than put forward a presciption to opt out. This would grant the maximum of alternatives.

1265 See, for instance, Davidson and Solomon op cit at 88. Another point has been made by Schotland op cit at 1451, who says that insiders might be distracted from single-minded devotion to their work for the corporation. With respect, I doubt this, because in competitive markets insiders must react very quickly to beat the market, and will thus spend very little time on their trading opportunities.

II. 'Opting out' and moral hazard

The legislative method currently in use provides more and more restrictions. However, even increasingly severe punitive measures have not effectively deterred insider trading. Our conclusion is that the time has come to modify the method rather than individual provisions. Elements of deregulation are needed, and companies should have permission to opt out of the present regulatory system. Efficiency might be improved by deregulation rather than by stricter controls.

It is necessary to consider some issues concerning firms which do opt out. Most doubts have been raised with regard to 'moral hazard'. It has been suggested in the literature that insiders should not receive any bonus other than shares of their companies until they own a certain percentage of the company.[1266] The intention behind this is to create responsibilities and at the same time to diminish the conflict of interest between principal and agent.

However, this would not seem to be an appropriate means of accomplishing this aim. Today, managers no longer stay with the same company for their entire working lives. Hence they are neither able nor willing to build up large blocks of shares of their companies. Many firms have simply become too big. How long, for example, would it take the manager to get a block of Daimler Benz shares?

In order to prevent the manager from dealing on the strength of negative information (moral hazard), it is suggested that companies should prohibit the manager (again by contract) from 'going short' or carrying out so-called 'empty' sales. Both are sales where the person who sells does not yet have the shares, but expects to buy them at a lower price (ie after the public announcement of negative information) before he has to deliver them to the buyer. Apart from this contractual clause, it is generally more likely that control markets for managers ensure that 'moral hazard' does not occur.

Also, given the tendency of worldwide conglometarisation, it is pointless to try to solve the problem of the separation of ownership and control via such a restriction in the context of insider trading. The above suggestion to grant permission to trade only when managers have reached a certain percentage

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1266 See also Schneider op cit (DB) at 1435; alternatively, companies could allow managers to own, but not to trade their companies´ shares, see also Carlton and Fischel op cit at 865.

of ownership has to be rejected. Only short sales should be prohibited.

III. Economics of regulation

The overall economic uncertainty surrounding insider trading makes it necessary to allow firms to opt out of the regulatory system. Economic findings ought also to be taken into account for the insider trading prohibitions that are maintained for firms which prefer to stick to the traditional regulatory system. These prohibitions need not necessarily be based on the agency approach.

It was found in Part I that the fiduciary approach to insider dealing ought to be discarded because, for the stock markets, there is often no real difference between primary and secondary insiders (ie 'tipees'). What consequence does this have for insider trading prohibitions? Trades by secondary insiders can affect the market in the same way as primary insider dealing. Secondary traders should therefore be included in the legal definition of 'the insider'. It is necessary to mould the definition sufficiently broadly to cover both groups.

Another important contribution which economic theory makes to the legal problem concerns the definition of the key element of 'non-public'. In this respect it was found that 'non-public' needs to be brought in line with the disclosure rules. Information released on ticker tape or made available in any other way to the capital market has to be regarded as 'public'. Thus, within the regulatory part of a Model Code, no one should be prohibited from dealing on the strength of information that has been published according to disclosure rules, or has been released of ticker tape.

Economic theory also suggests that market information ought to be included in the definition of inside information. Since share prices incorporate both types of data, ie information indogenous and exogenous to the company, the market can be affected by dealing on either of them. Future law must take this into consideration and explicitly include market information in the definition of inside information.

Our discussion of economic theory has also yielded the conclusion that the production of negative information which can cause 'moral hazard' is extremely important. This is also true from the point of view of an ordinary investor who is less troubled by a gain (based on positive information) which he was unable not realise than by alleged losses caused by late disclosure of negative information. This needs to be taken into consideration. Companies may have an interest that none of their managers deals on negative information. Even if these companies wish to opt out, they might still want their securities to be monitored with regard to negative information. This additional option should be granted by a Model Code. Of course, if companies wish that their shares are monitored, they have to pay a certain amount towards the monitoring costs.

In the following chapter we shall now discuss what results from the legal analysis in which we have applied the above economic findings. This step is necessary for our aim, which is to suggest what model insider trading provisions ought to take into account.

Chapter 2: Results from the comparative examination

In all three countries the present legislation reflects a transitional process between old insider concepts such as 'fairness' or 'morality' and new approaches, which seek to ensure market protection. But none of the examined laws is based on a clear concept.

A. Conceptual shortcomings

Above all, the three laws do not make it clear the economic hypotheses on which they are based. Their provisions are also not in line with modern economic findings, to say the least. One finds lots of positive-sounding, but rather abstract policies such as 'investor protection', 'functioning of the market', or 'investor confidence'. But these policies are not really reflected by the provisions. 'Investor protection', for instance, is still interpreted as absence of *individual* 'harm' which is allegedly caused by insider transactions. Hence the superfluous attempt to create (South Africa) or discuss (Europe, England, and Germany) civil remedies against insiders. The first thing that a Model Code ought to state clearly is the policy it pursues, and the way in which this policy is to be interpreted.

I. Legal concepts and definitions

From unclear legal concepts follow vague legal definitions of key elements of insider trading. For instance, most of the provisions relating to 'tipees' are defective. In the German legislation severe shortcomings with regard to the direct insiders is be noted, too.

II. Market protection approach and a new criterion for the definition of the insider

The most commonly accepted approach to insider trading today is the 'market protection' approach. But if insider trading prohibitions are to be based on the idea of market protection, then this concept needs to be clarified. Otherwise it remains vague, and cannot be used in the application of the law to individual cases. Who, for instance, is an insider in terms of market protection? Since the fiduciary concept of defining the insider has been discarded, an insider need not owe fiduciary duties to a company. But what new criterion must a person meet to be an insider when the intention of the law is to protect the stock markets? First of all we need to discuss what market protection actually means.

A fairly good description of the modern 'market protection' approach can be found in the preamble to the Council of Europe´s convention on insider trading which

> 'considers that such behaviour (ie insider dealing) is also proving dangerous for the economies of the Member States (ie the allocative function of the markets), and in particular for the proper functioning of the stock markets; ...'.

Even though the examined laws take 'market protection' as their starting point, their provisions are not in line with it. The different laws are either based on individualistic (see civil remedies in South Africa) or fairly one-sided and group interest-oriented concepts (see defences in England). The insider provisions in these countries do not really reflect a proper market protection approach.

Market protection can be interpreted in different ways. A Model Code ought to prefer one clear interpretation. It ought to formulate provisions which are in line with this interpretation. The economic discussion has made it abundantly clear that insider prohibitions are not a device to enhance prompt disclosure. 'Market protection' as a term underlying criminal statutes ought to be more precise and clear. It is submitted that the concept of market protection includes the opportunity for companies to opt out of the regulatory scheme. Companies opting out must make a public announcement of their decision. An investor who does not want to incur the risk of trading with an insider of such a company, must be able to avoid those companies´ securities.

From the perspective of this modern legal market protection approach (chosen, for instance, by the Directive), the public goods protected by the law are the functioning of the market and its competitiveness on an international level. Once fiduciary or misappropriation concepts are discarded, it would, however, seem important to introduce a new criterion which serves to describe what is necessary for a person to have or to be in order to be called an insider. The transactions of a barman, for instance, do not really undermine the proper functioning of the stock market.

One new criterion to define insiders could be that the person does not only possess inside information, but must also bear some kind of responsibility towards the stock market. All persons who, for instance, systematically produce company or market data which influence the prices in the market, can be regarded as having a certain functional responsibility towards this market. This includes directors, managers, substantial shareholders, bankers, brokers, financial advisors, market makers and other financial intermediaries.

Other people, such as lower-ranked employees and secretaries, lawyers, and advisors, as well as most of the recipients of information who are not professionals, lack such a responsibility for the market. They do not regularly produce information that is incorporated in stock prices. For such persons to be regarded as insiders they should be required to meet an additional criterion: they should either come into contact with sensitive information on a regular basis, or their specific transaction must be so important (eg large amount of shares traded) that it can undermine investors' confidence in the functioning of the market. However, in cases where it can be established that the impact of that particular dealing by such a person was minor, these persons should not be held liable as insiders. The famous problem of office-cleaners, taxi-drivers, or the barman overhearing a conversation between two executives can be solved on this basis. All these people would not be included in a definition of the insider, because they all lack responsibilities to the stock market.

III. Concluding remarks on underlying concepts

The most complete and detailed law on insider trading is the English. Yet the English provisions do not really seem to prohibit insider trading, but to protect dealings by securities industry people. This becomes particularly clear when one examines the element of 'non-public'. It is provided that information is public when those 'likely to deal can readily acquire it'. This serves the interest of only one group because bankers and brokers are always 'likely to deal', in fact it is their profession. Our democratic approach does not exclude the fostering of group interests. It is, however, doubtful whether the functioning of the market is best protected when stock market professionals feel safe. A Model Code ought to protect the other participants' interest (namely those of shareholders and companies) as well.

A similar imbalance of interests is created by the English 'defences' to allegedly indictable offences.[1267] Many of these defences are designed for the purposes of market professionals. Yet most of these defences are superfluous. Take, for example, the defence available when the insider 'would have dealt in any event'. For a conviction it must be established that the insider had the intention to exploit informational imbalances. Hence there was simply no need for this defence. In this regard the German legislature has been far less loquacious. A Model Code ought to rely on clear concepts rather than on spelling out every single detail. It seems that most defences need not be expressly stated in provisions since they follow from a 'normal' understanding of what insider trading is.

No doubt financial service people contribute to the allocational functions of the market. Yet these people are 'outsiders' compared to firm managers who produce the actual information. Where the normal outsider can be systematically outperformed by other outsiders (ie market professionals), it seems likely that he would prefer to be outperformed by real insiders (eg managers), especially if the manager must accept a reduction in salary in return.

The test to be applied to every insider legislation is whether the redistributional effects which it produces serve the investors´ interests. If not, there is not even market protection in the sense that the investor feels protected. Yet none of the examined laws brought about a clear redistributional effect in favour of the investor: the civil remedy provided by the South African legislation does not work, and the German law does not even reveal which public good is protected. All this leads to highly inefficient provisions. If efficiency equals justice (see, for instance, the Chicago Law School), these laws are not just, because they are not efficient.

We shall now examine what can be learned from the comparative analysis, and how we can incorporate these legal findings in a Model Code.

1267 For the group theory approach to insider dealing cf Manne op cit (Cato Journal) at 941 et seq.; cf also Haddock/Macey op cit at 314.

B. The approach to 'inside information'

The element of inside information is the essential one because, without either good or bad news not generally available, there will be no insider dealing. A Model Code ought to be clear about the significance of 'inside information'. Most laws (for instance the German) still prefer to discuss at length who the 'insider' is, rather than accepting that, on principle, all persons in possession of inside information are insiders,[1268] and that what really counts is the scope of the definition of inside information.

A Model Code ought to make clear that, currently, any insider trading prohibition is based on the semi-strong form of the ECMH (ie the hypothesis that information is not reflected in the prices of securities if it is not generally known). As soon as this hypothesis becomes rebuttable it would no longer make sense to regulate insider dealing at all. This has important implications for the definition of 'non-public'.

I. Which information shall be included?

The first issue that has to be dealt with is the types of information that the definition should include. The definition must be sufficiently broad so as to ban harmful insider trading. Yet it must also take into account the market's need for liquidity. Too broad a conception of information will reduce the amount of beneficial trades and thus decrease market efficiency. A Model Code ought to avoid such a result.

The comparison of the three laws has revealed that only information with greater significance has to be included. Information is of significance for the price development when market participants would normally buy or sell on release of that type of information. It is not certain whether the law should narrow the scope of the definition eg through the element of 'price-sensitivity'. It appears that formulations such as 'information which is likely to materially affect the price of a security' result in a high degree of uncertainty. No one can be sure which information is caught and which not. As a result, 'good' trades may be deterred as well. What is needed is a

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1268 It has been suggested to introduce a new criterion for the definition of the insider, ie a criterion which relates to responsibilities a person has towards the stock market, and no longer to his position in the companies.

list[1269] of events which are to be regarded as potential inside information. The information in such a list can relate to either companies or markets.

1. Information relating to companies

It is obvious that both good and bad information about companies (including the prospects of the company) must to be included. Let us call such information 'internal' or 'endogenous' data. All three examined laws sensibly include such information. Yet none of the laws provides further indication as to how to put flesh on the skeleton. All the provisions defining inside information remain abstract in the sense that they merely include information that 'relates to a company or to companies'. Does this include, for instance, a situation where a member of the board falls ill? He can be the most important manager, and still the information might not 'relate to a company'.

A Model Code should be more specific. This is also required by economic theory that teaches us that there are only few types of information which can really be exploited, such as take-over situations or earning announcements. It appears to be a good legal technique to provide a list of information that is potential inside information. Sometimes information that has an impact on stock prices might not be caught, because it is not contained in the list. However, legal clarity seems preferable; and if excluded information is found to be relevant, the list can always be extended.

2. Market information

The second basic type of information which needs to be included in the definition is 'market' information[1270]. Such data is 'exogenous' to the company, but may nevertheless affect the expectations that investors have for the future business prospects, or may alter their present estimation of the company.[1271] Hence such information can have impact on prices and

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1269 Assmann, in Assmann and Schneider op cit at 116 et seq., rightly refers to a 'catalogue' of relevant information based on the 'Leitfaden' (engl.: orientation help) provided by the German Stock Exchange AG.

1270 Tippach (Marktinformation); cf Fleischer/Mundheim/ Murphy op cit at 799 et seq.

1271 The view expressed hereinbefore (see for instance Hannigan op cit at 113) differs should therefore be included in the defintion. The three examined laws differ in this regard. The English and the German insider trading laws include market data, yet not all types, whereas the South African law does not include it at all.

Take, for example, a recommendation about a stock (eg by the retail department of a bank), which is based on generally available facts.[1272] Such a recommendation about a company is certainly not endogenous to that company. But surely a recommendation can have positive effects on the price of the stock and should therefore be regarded as potential inside information. But is it market information?

A different kind of market information was used by Blyth. In SEC v Blyth & Co, Inc.[1273] a broker obtained non-public information about the terms of new government financings from an employee of the Federal Reserve Bank of Philadelphia, who had received it from the Treasury. Blyth effected transactions in outstanding government securities. Was this a case of insider trading? The terms of new government financings are not company information. But maybe it was market information. A Model Code should be clear about both cases.

Another problem is posed by take-over situations. Even though some think

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from the defintion which is given by Fleischer et al op cit at 799, who contend that market information refers to information about events or circumstances which affect the market for a company´s securities, not, however, the company´s assets or earning power, idem at 799. Those commentators think that a recommendation is subsumable under the term 'market information'. This is probably correct because such a recommendation does not affect the assets of the company. Yet, it is not only the market in the securities of the company which is affected. Even if such a recommendation results in an increased demand, the CAP model teaches us that this would not alter the price if there is no new information about the company. The price reaction subsequent to a recommendation is due investors´ altered estimation of the company. Without new information (or, if the recommendation is exclusively based on publicly available information, a new interpretation of the already available information) the price would, on the basis of the hypothesis of perfect substitution, definitely not change. Hence the definition suggested here is correct.

1272 Fleischer et al, idem at 799

1273 See 'In re Blyth & Co, Inc.', SEC Exchange Act Release No 8499 (Jan 17, 1969), in [1967/69 Transfer Binder] CCH Fed Sec Law Rep 77, 647.

that this is the classic inside infomation, the prevailing opinion[1274] in the literature takes the view that information about take-overs is market information because it mainly concerns share transactions. This would have major implications for insider trading laws that do not include this type of data (eg the South Africa law). This view is, however, not correct. Taking into account the fact that every merger produces synergy effects, a take-over changes the real (or at least the expected) future earning power of a company. Also, if the buying company has carried out the research which leads to the take-over (which usually happens because the target's shares are found to be priced incorrectly ie too low), and such research is part of the company's business activities, then it is obvious that the information is endogenous to the buying company.

On which concept[1275] should the inclusion of market information be based? It would seem possible to base its inclusion on the old fairness approach, because it would seem to be equally unfair to deal on superior knowledge about market data. But we have discarded the fairness approach because insider trading is not per se unfair. One might also want to refer to fiduciary principles. In most cases, however, it is impossible to include market information on the basis of a fiduciary relationship, because people like the employee of the Federal Reserve Bank do not have a fiduciary relationship to shareholders.[1276]

Only the suggested version of the market protection approach allows us to include market information. The above Blyth case can be solved on this basis, too. An employee of the Federal Reserve Bank has certain responsibilities towards financial markets. He can therefore be regarded as an insider. Hence the information stems from an inside source, and the person who finally deals on the strength of that information can be regarded as a secondary insider and is therefore liable.

We must also consider whether trading on market information should be

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1274 See Fleischer et al op cit note 138 at 799; Davies op cit at 248; but see McVea op cit at 70. I have stated elsewhere, why it is correct to assume that take-overs and mergers in general are company information, cf Tippach 'Banken' at 196 et seq.

1275 For a concise overview of the relevant approaches see Scott op cit at 805-815.

1276 See Chiarella v US, 445 U.S. 222, 231 fn 14 (1980), where the view is rejected that those who have regular access to market data are insiders by virtue of the access alone, without a relationship between parties that creates duties.

monitored when companies 'opt out'. Can the managers and shareholders of such companies include market data in their agency contract? The problem for such a company may be that market insiders benefit from market information who are not bound by the contract between managers and shareholders. This means that people can profit from insider trading in a company's shares even though they have not accepted a reduction in salary. On the other hand, the sooner new information is incorporated in the stock price the fairer the pricing. All shareholders benefit from this market mechanism. Besides, all monitoring is costly. If the company wants to have its shares monitored, this gives rise to transaction costs. It is therefore suggested that shareholders should prefer that insider trading on market information is not prohibited.

It is yet another question which types of market information should be included in the prohibition. Does it make sense to catch all types of market information? It is certainly correct to include recommendations and the identity of parties who buy or sell, because both data are likely to influence prices. The same is true for statistical data relating to crucial sectors of the economy eg the car-producing firms in Germany or mining companies in South Africa. Important information for these sectors of the industry would be export restrictions or the invention of an artificial diamond. These types of information affect the expectations of future income streams of companies and should therefore be included.

It is, however, suggested that political data such as the death of a politician or the result of elections should not be included in the definition, even though they normally have an impact on securities markets. But this kind of political data is not per se related to companies or stock markets. It is therefore not an inherent or specific risk when investors buy stock (plot prices may also lower when an important politician dies). Several observations indicate that it is more appropriate to exclude general political data. They are exogenous to both companies and markets.

Also, the word 'insider' connotates a certain degree of institutionalisation of his access to information. Insiders are generally persons in positions which allow them to systematically exploit inside knowledge. The production of such political information cannot, however, be institutionalised. One cannot 'produce' major events in politics; rather, they happen incidentally from time to time. Hence contraventions would only occur irregularly depending on the kind of employment of the person using the information. Outsiders would therefore not be demoralised by the constant threat to be outperformed by such insiders. And possible demoralisation of investor confidence is currently the best reason to prohibit insider trading.

General political information relates to the market as a whole. Thus trading in *any* security would have to be controlled irrespective of the identity of the trader and the quantity of stock traded. This would increase monitoring and detecting costs, which is not beneficial for the market.

Finally, people who work in such positions hold very important administrative functions, and they must therefore be reliable, a fact which can justify to insert a clause in their contract of employment[1277] which prohibits them from dealing in shares shortly before the announcement of political events. These people are chosen to maintain crucial functions of the state and they deserve some trust. And for them, of course, there is no possibility to 'opt out' of the regulatory scheme.

3. List approach instead of 'materiality'

The examination of the three laws did not provide much clarity in regard to the possible contents of inside information. The South African and the German laws require for conviction that the insider deals on the basis of the information. The English law seems to require for conviction that he deals with view to making a profit. Both have to be criticised. Economically, the price of any commodity reflects subjectve measurements of a good´s utility.[1278] Subjective measurement by investors is therefore a mathematical function of the information they have about the commodity. In securities markets we find that a variety of opinions are present at all times. Hence heterogenous expectations prevail.

We do not have an economic model which explains how prices adjust under the premise that investors have heterogenous expectations. In other words, we do not know what a specific investor´s reaction to information looks like. Therefore, if the definition of the information is vague, the courts will be unable to identify the piece of information upon which the insider´s intention to buy or sell was based. And as long as the information upon which the insider based his deal cannot be identified, his 'guilt' cannot be

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1277 Barry op cit at 1374 asserts that most government employment contracts specifically proscribe use of official information for personal gain.

1278 Manne op cit (Cato Journal) at 935.

proved. Hence the unhappy attempts under the US insider prohibition to apply different forms of a 'reasonable man' test to explain why information is supposedly material. As we have seen, the 'reasonable man' tests give too much discretion to the courts, and therefore create too much insecurity for insiders and other traders. Economically, this insecurity results in less tradings and decreases the liquidity of the market.

A Model Code ought to exclude inside information of minor importance because trading on such information would be too difficult to detect and hence contraventions too difficult to prove. The law should rather provide a list of supposedly major events. If one of these events occurs, that will suffice to establish that the insider had the information before he dealt. He may then raise defences such as 'the information did not have the potential to produce relevant price shifts'; but the burden of proof would be upon the insider and no longer on the prosecution.

Today, all laws on insider trading try to achieve the exclusion of less important information by adding the requirement of 'material' or 'materially affect the price'. But how is one to interpret such formulations? Normally, no guidance is given by the legislation. The result is that subjective views prevail in the judicial practice, even though they may be disguised in the objective term of the 'reasonable investor'.

The English Act sensibly provides that 'inside information' includes information which relates to the *value* of the enterprise. Thus, there is no need to establish that the information is (or was expected to be) material for the price development. It suffices that the information as such is important for the (value of the) company. This approach is good because it results in more security. It is also beneficial for the legal analysis, because one does not get bogged down in the 'discussion of percentage' like, for instance, under the German law. The English law provides a much more pragmatic approach in this regard. A Model Code ought to take this into consideration and provide a list with important information. The materiality requirement should be left out altogether. Information is material in this sense when it is contained in such a list.

Another question is whether or not the law should require an actual price shift. None of the examined laws provide for such a requirement. This is correct because it is to the insider's benefit if all price shifts have occurred due to derivatively informed trading[1279] (or other insider trading), so that he can re-sell the stock before the information is even announced. A consequence of that might be that the price does not change at all on disclosure, and the insider would not have contravened the law, even though he may have realised a huge profit. As long as we assume that insiders are acting in the markets, the price shift 'potential'[1280] (as opposed to actual price shifts) is all we have to look at. Otherwise the regulation would create an incentive for the insider to encourage others to deal: because the more dealings that take place before the announcement, the smaller the actual price shift on day 'X' when the public announcement is finally made.

For these reasons it is suggested that, instead of applying abstract formulations such as 'likely to materially affect prices', the law ought to provide a precise list of what constitutes relevant inside information. From an economic point of view this suggestion is supported by empirical evidence, since it was reported[1281] that more than 80% of all SEC insider trading cases involve trading immediately before corporate take-overs and earnings announcements. The reason for this may be that it is easier to prove insider offences if these major events occur. Taking this into account, a Model Code should at least include in a list-definition of inside information: take-overs; mergers; the most relevant market data; earning anncouncements; and information related to the capital of a company.

1279 See in particular Givoly/Palmon op cit, who suggest that the insider produces price effects through his presence on the market rather than through the information itself.

1280 See from the point of view of a German economist the very interesting article by Loistl, 'Empirisch fundierte Messung kursrelevanter Tatsachen', Die Bank 1995 232 at 234 et seq.

1281 Dooley op cit; see also Seyhun op cit.

II. The element of 'non-public'

'Inside' as opposed to 'made public' is used quite frequently in insider dealing laws, but on closer examination the term proves to be circular because one does simply not find 'inside' information that has already been made public. Vice versa, there is no public information which is at the same time still inside. A difference between 'not made public' and 'inside' is very hard or even impossible to conceive. Only non-public information can affect the price of a security. It can be argued that the element of 'non-public' does not really add anything significant to the term of 'inside' information. Defining inside information by reference to information which has been made public, appears tautological.

Economically, if information no longer yields profits to the dealers in shares and options, it is no longer inside.[1282] But when would that be? We simply do not know. We must concede that every definition of the element of non-public necessarily produces some uncertainty. The second best alternative is then to define this element very precisely and minimise uncertainty. Uncertainty is always a hindrance-factor to the efficiency of the market. The definition should therefore be designed in such a way that it permits a maximum of beneficial trades.

As we have seen, the ideal of equal distribution of information amongst investors is unachievable. Therefore, there is most probably no need to allow for extra-time to digest the news after publication.

Our discussion of the economics of insider trading has also yielded the conclusion that there is a substantial likelihood that outsiders, on an average, lose to market professionals. But one has to accept that this is part of the general economic structure on share and option markets. Professionals have a quicker access to new information. A Model Code of insider trading should therefore not try to erase these profits. Where shareholders opt out, and thereby deliberately redistribute expected trading profits to their insider managers, they would at least know who is making these profits. And these 'real' insiders are able to trade long before the announcement of the news, a fact which prevents hectic price movements shortly before announcements. Such price movements are usually caused by secondary insiders who come and buy or sell all at once.

1282 See R. Schmidt op cit (Aktienkursprognose) at 172.

A clearcut definition needs to be found. This was also confirmed by various economic theories such as the neo-classical 'freedom approach'. According to this economic theory only clear legal definitions enhance freedom. It is suggested that the clearest distinction between 'public' and 'non-public' can be made at the time of disclosure. Disclosure is understood here in the sense of 'disclosed in a legal way' ie according to official disclosure requirements. Once the information is published according to the general publishing rules, it is no longer 'inside' in terms of the insider prohibition. A Model Code ought to define 'non-public' as follows: if the release of the information is effected through a company's announcement office on the stock market, the information is regarded as published when it comes in on ticker tape and is available for those who have access to a ticker. The same should apply to data coming in on ticker through the information net.

This definition should further apply to information published on any stock exchange on which the security is traded, because the price adjustment process takes place all over the world. If, for instance, information relevant for Daimler Benz is published in New York according to the requirements of the NYSE, the information should also be 'public' in the German market. The English law on insider trading information 'may be treated as public' if it is published outside the United Kingdom.[1283] This does not take into account that traders and markets are connected worldwide, and that price adjustment happens quickly no matter on which stock exchange information is published. Also, in many cases companies have to publish the information on all markets where their shares are traded.

A Model Code should not further enhance the trading benefits of market professionals by extending the scope of information that may or might 'be treated' as public. According to the English definition of 'non-public', for instance, information may also be treated as public where it can be acquired only by persons exercising diligence.[1284] If these exceptional circumstances are applied throughout, this will result in a kind of exemption for market professionals - given that the definition of 'non-public' is already quite favourable for these market professionals. The trading prohibition would redistribute wealth from the shareholder to financial service people. In that event shareholders should definitely decide to opt out.

1283 Sec. 58 (3) (e) of the Criminal Justice Act 1993.

1284 Sec. 58 (3) (a) CJA 1993.

Further elements, such as 'precise' or 'specific' are not necessary for a definition of non-public information. If the information is not 'clear' or 'specific', for instance, investors will interpret it in different ways and thus the price adjustment process will happen slowly enough to afford protection for all investors. Economic studies have shown that, where ambiguous information is revealed, the price adjusts slowly, and there may even be adjustments over several months.[1285] It can never really be proved that someone dealt on the strength of such information. Hence a certain 'precision' is already entailed in the concept of information which makes it unneccessary to complicate the definition.

It follows from this approach that we do not have to consider issues such as whether the information is 'public' if it is contained in obscure journals. Information is generally not public if the publishing requirements are not met. And that is an issue for the law on publishing requirements, not, however, for the insider trading provisions. The insider may, however, prove that the information was already 'made public' otherwise, and that he was therefore unable to realise a profit.

1285 Carney op cit (Signalling and causation) at 882 fn 87; see the interesting overview of such studies given by Wang op cit ('Some arguments') at 364 fn 60 et seq.

C. Who is - and who should be an insider?

We have seen that the three laws do not provide coherent definitions of the 'insider'. It was argued that the main reason for this is a lack of conceptual clarity. In South Africa, for example, the company insider approach is still applied to a large extent. If, however, 'investor protection' is the declared goal of the legislation, why should the recipient of information have to know that the information was obtained through theft (eg in South Africa)? Why should the 'tipee' be prohibited to deal only if he is in possesssion of the information, but not when he is given a true tip (eg in Germany)? Why should the employee not be an insider when he steals information which has not previously been entrusted to him? Under the English provisions it is possible that such an employee would not be considered as an insider, if the courts maintain the former fiduciary requirement. In other words these provisions do not correspond to the intention of the law to cast the net widely enough and to protect the market.

The South African definition of the insider was found to be the broadest in the sense that more persons are included as 'insiders' than under the other examined laws. Yet this definition is to a large extent based on the old fiduciary approach and is therefore in many aspects under-inclusive. Without a clear notion of the protected good, the courts are unable to distinguish between beneficial and non-beneficial trades, even though this distinction ought to be the ultimate criterion for conviction. Surely when the trade is beneficial, the market needs no protection.

With regard to the German and English laws on insider trading, it is necessary to reconsider their attitude towards the situations where a person obtains the information through a wrongful act. The contribution of the German law to this debate is that it is essential to define the concept very precisely. All market participants, especially insiders, must understand what the essence of the crime is. Surely stealing of company information is a crime irrespective of whether or not it is used for insider trading. And because it is irrelevant for the market process whether the information was stolen, information obtained through a wrongful act should be included. It is suggested that a Model Code ought to include the thief in the insider definition. There is also the possibility that the thief sells the information to a professional dealer. If the thief is not regarded as an insider, the information might not stem from an inside source, and hence the professional dealer would not be caught as an insider.

A Model Code based on market protection should include in the insider definition: directors; managers; people who obtain information due to their profession, either because they have access to it, or because they misuse their position and wrongfully obtain it; people who advise (legally, or financially) the company and get information through it. Also included should be shareholders, although empirical studies[1286] have furnished evidence that, with regard to insider trading, even large shareholders are less successful than executives. Generally, all the above also meet the additional criterion[1287] of having certain responsibilities towards the market. If they lack such responsibilites the courts may acquit them.

When companies opt out of the monitoring system, substantial shareholders must refrain from insider trading. Once they have agreed that insiders may trade in exchange for a reduced salary, the shareholders cannot be allowed to profit twice.[1288] However, normally, the substantial shareholder gets some sort of remuneration for his control function in the company. It is therefore conceivable that there is a contract between the substantial shareholder and the other shareholders permitting him to deal on inside information. In that case his insider trading profits can be regarded as remuneration.

A Model Code should also include as insiders those third parties who obtain information through a wrongful act other than theft (these are not included, for instance, by the Directive). Surely, all market professionals, such as research analysts, financial journalists, investment bankers or brokers should also be included, since they all have some kind of responsibilities towards stock and option markets. It goes without saying that tipees should also be included. Such 'recipients' of tips are the real parasites because they do not produce valuable information for the company.

On the other hand, if it is established that persons other than those listed in

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1286 Seyhun op cit at 202-207.

1287 See above Part II, Chap 2, A, II.

1288 It has been argued herein that substantial shareholders should be allowed to profit for two reasons: firstly, their task of monitoring the management is beneficial to the other shareholders; and secondly, they incur particular risks insofar as their investment is not diversified (exposure to firm-specific risk). See Demsetz op cit at 313-315; for the opposite view see for instance Davidson/Solomon op cit (The agency origins of insider trading) at 88.

the previous paragraphs obtained information by mere coincidence, these persons ought not be held liable. A Model Code should provide a special defence taking into account the economic finding that investors are deterred only when they are systematically outperformed. This is not the case when a person accidentally obtains one piece of information (eg in the case of the barman). Such a person should be able to raise the defence that he was unable to outperform the market on a regular basis. It is suggested that such a defence should apply only to the person himself, not, however, when this person passes the information on to someone who is able to use such information regularly, for instance a broker. In this case it is the broker who ought to be held liable for committing insider trading. The other person (ie the barman) may be held liable for aiding and abetting, not, however, for insider trading, because he cannot normally outperform the market.

Economic theory furnished good reasons why transactions and the passing on of the information by 'recipients' of tips or of information, need to be penalised. In terms of price effiency their (ie the tipees´) trading is certainly less beneficial for the market than real insider dealing. It contributes far less to a correct pricing than insider trading itself. If anything, their trades are more likely to upset the balance of the market. A Model Code ougth to include them and prohibit their trading.

What should happen to tipees in cases where the company opts out of the regulatory scheme? Sometimes, the insider in such a company does not have the financial means to exploit the information he produces. It is submitted that the insider should then be allowed to sell the information to such tipees. The recipient (tipee) would 'represent' the insider on the market, and the other market participants would still sometimes be able to decode the price or volume signals that are sent by his trades.[1289] For the shareholder it does not make much difference whether he trades with a company insider or a recipient, because the cut in salary would remain the same, and the shareholder's profit would be increased in any event. The manager would have to share the profit with the tipee. Since the manager knows about his personal financial situation when he enters into the contract permitting him to trade, he can always raise this point during the negotiations.

1289 Remember that it is not always necessary to know the identity of the trader in order to decode such signals. It may therefore be irrelevant who actually trades.

D. Offences and defences

I. The offences

The offences are twofold: the insider can either carry out direct transactions (dealing offence) or he can impart his inside information to another party (counselling and procuring offences).

1. Dealing offences

A Model Code ought to prohibit every type of insider trading on stock markets (ie in all securities, indices, options, futures, warrants) because they can all have a disturbing impact on the markets. This holds true irrespective of whether the deal is for the insider´s personal account or the account of a third party. If the third party knows about the insider transaction, he ought to be held liable for aiding and abetting. The dealing prohibition should apply to both access insiders and recipients of information, since economic theory teaches us that their transactions can have the same effect on the price development.

It follows from the examination of the three laws that 'dealing' ought to encompass all kinds of transfers of securities, rights or the creation and putting to an end of such rights[1290]. Any security can be affected by the information, even state bonds, the prices of which react to an increase in interest rates. Our examination of the three laws has revealed that their provisions try to define 'securities' in all-inclusive lists. This does not seem to be the right approach. The term 'securities' ought to include all securities which are traded on exchange floors, since it would really make no sense to exclude one or other security. Besides, the current list approach makes the prohibition unnessecarily long and complicated. A Model Code should crisply define securities as all traded securities.

Our examination has also shown that it is a fundamental requirement of most insider trading laws that the dealing be based on the information. It seems that only the English law does not so require. The English provisions do, however, provide something similar. A defence is available where the insider can prove that he had not expected the information to yield a

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1290 See, for instance, s 55 (2) (b) and (3) (b) of the CJA 1993 in England.

profit.[1291] From this we can conclude that an offence is commited only when the insider acted in view of a profit. Yet this formulation brings about a result very similar to the formulation 'dealing on the strength of information'. He who exploits information wants a gain, and he who expects a gain necessarily thinks that his particular information will yield a profit.

It has to be noted though that the English formulation is favourable for the prosecution insofar as the circumstances giving rise to a defence must be proved by the accused. It is suggested that a Model Code ought to choose the English method. Once it is established that the insider was in possession of valuable inside information, he ought to be deemed to have made use of it in order to exploit it. It ought to be provided that an insider who traded while in possession of inside information has committed the dealing offence unless he can raise a defence. This is also in line with the above suggestion to limit the scope of potential 'inside information' to a small list of potential insider events. It would not appear undue to facilitate the task of the prosecution, since only major events are included in that list.

2. Counselling; procuring the information; or encouraging others to deal

None of the three examined laws extends all prohibitions to tipees who counsel or procure information. Under the market protection approach this is not consistent, because recipients of inside information represent the informational advantage which was originally conferred on the insider. The recipient does not seem to induce as much derivatively informed trading as the insider, since the market does not easily conclude from his transaction the existence of new information. Thus the recipient's transactions are less economically beneficial. The same reasoning applies to subtipees. It is therefore suggested that a Model Code should include all forms of counselling or procuring activities by recipients no matter how far they may be from the inside source.

Another shortcoming revealed by the examination of the laws is that sometimes the recipient is required to come into posssession of the information itself (this is clearly the case under the German law). Yet the information is also exploited, where the transaction is based on a tip. Hence

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1291 See s 53 (1) (a) CJA 1993.

it is suggested that a Model Code should extend the prohibition and include tip-based transactions.

A Model Code should also clarify that a tip (or recommendation) is deemed to be based on the inside information where it can be established that the person who made the recommmendation was in possession of it at the time of the recommendation. The fact that a recommendation is about to be published, itself constitutes inside information, whether it is based on public information or not. The recommendation does not constitute an indictable offence, if, and only if, it is based exclusively on public information. The following formulation is suggested for a Model Code: A recommendation is not based exclusively on public data if the person who made the recommendation was in possession of price-sensitive information. There would hence be an exemption only where no non-public information is involved in the recommendation at all.

II. The defences

The example of the English defences has revealed the extent to which the law can be influenced by special interest groups. Taking into account that the intention of the law is to protect the (small) investor and enhance his confidence in the functioning of the market, the kind of defences we find in the English law are clearly defective.

Solely the defence for market makers is appropriate[1292] because their duties are essential for the market. Trading in order to fulfil these duties should be exempted by a Model Code in order to avoid uncertainty amongst these professionals. There is also sufficient economic support for this view. Economic theory teaches us that information which is shared, and known to be shared, by two or more risk neutral market makers engaged in price competition, will be fully incorporated in their price quotes, and command no bid-ask premium.[1293] Thus, provided market making is competitive, ordinary investors are protected by the quick dissemination of information amongst market makers. Regulation ought to take this economic finding into account.

1292 See for example s 1 (1) (a) and (b) of Sched 1 of the CJA 1993 in England.

1293 King/Roell op cit (Insider trading) at 169; see also McVea op cit (Financial conglomerates) at 60 et seq. fn 108.

However, if the trading by a market maker is not 'professional', but occurs on his private behalf, it should to be prosecuted. In this case the market maker abuses his position.

Our examination has revealed that it is good to exempt transactions which are effected for political and national economic purposes.[1294] Exempting such transactions is sensible because by doing so the legislator creates the framework of political stability. We simply have to assume that 'State actions' are beneficial for those who have conferred their power on the State. If these actions are not in the interest of the public good, the State will lose legitimate power anyway. A Model Code should therefore include this exemption.

It is doubtful whether one should provide a defence for transactions aimed at price stabilisation. We have seen that, if the insider prohibition works efficiently, disclosure of new data will result in major price shifts. Insider trading provisions implicitly say that sudden price shifts are welcome. If this is so, why it should be necessary to smooth the price adjustment process in cases other than insider trading. From this point of view, a Model Code should not exempt price stabilisation from the insider trading prohibitions.

1294 See, for instance, Article 2 para 4 of the European Directive on insider dealing.

E. Appropriate sanctions

The final issue which has to be dealt with is what sanctions are appropriate for the offences committed. This is indeed a most complex problem.[1295] As highlighted above, insider dealing regulation has an impact on market efficiency. This holds also true for the problem of appropriate sanctions. It is important to take into account economic models that explain the economic consequences of certain sanctions.

In theory, the 'appropriate' sanction ought to contain an optimal mix of certainty of conviction and severity of punishment to minimise the social loss of crime.[1296] Individuals react to changes in both variables, ie to the loss (eg imprisonment) they incur if they are caught, and to the probability of being caught and punished.[1297] Over the years we have noted a constant increase of sanctions without more success in combatting insider trading. It seems that the sanctions have been increased draconically because most insiders were not caught. If the probability of being caught is zero, the mathematical equation is also zero in the sense that the deterrent effect of the sanction has failed, regardless of the severity of the punishment.

Three possibilities for an appropriate sanction have been mooted. The first is that the insider should account to the company. The drawbacks are obvious: the company does not normally suffer losses from insider trading[1298], so why should the company profit from insider trading although such trading is not allowed. And where the insider is a substantial shareholder and permitted to trade on inside information, he would benefit either from insider trading or from the redistribution of the insider gain to the company; thus he would be left with a net profit on his dealing.[1299] This remedy cannot be appropriate.

The second possibility is that the other party to the contract should be given a right of action against the insider for rescission or damages.[1300] This

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1295 White, 'Towards a policy basis', (1974) 90 Law Quarterly Review 494 at 507.

1296 From a South African perspective Botha (The economics of the crime) at 145 et seq.

1297 Botha, idem at 149.

1298 NB: The insider trading issue is of course different from the liability of directors' for projects in South African and English law.

1299 White op cit at 502.

1300 White, idem at 502.

approach has already been rejected in the subsection which dealt with the sanctions provided by the South African law (cf above p. 304 et seq.).

The third possibility is the one that currently prevails ie the criminal sanction. This type of sanction is consistent with the idea of market protection because the functioning of the market is a public good. What a Model Code needs to determine is the maximum penalty to be imposed.

Another possible sanction imposed by the courts is banning the insider from the exercise of his professional occupation. In this regard the recent English case R v Goodman[1301] is paradigmatic. It must be borne in mind, though, that the case was decided under the old Company Securities Act 1985. The most serious sanction applied to Mr Goodman was under s2 of the Company Disqualification Act 1986 (CDA), banning him from being associated with the management of a company for a period of ten years. The 1985 CSA required the insider to have a defined connection with the company. Mr Goodman, a chartered accountant and former chairman of a public company, was convicted of insider trading. He had avoided a loss of approximately L1m when selling shares ahead of bad news. The first problem which arose from the facts was whether the offence had been committed 'in connection' with the management. It was held that the test to determine if the offence was 'in connection with the ... management ... of a company' for the purposes of s 2(1) of the CDA is whether the offence had some relevant *factual* [1302] connection with the management, and not[1303] whether the offence related to the management of 'a company', eg filing returns, or had been committed 'in the course' of managing a company.[1304]

As we have seen above, the CJA 1993 does not require that insiders have a connection with the corporation, and therefore this connection is no longer an element of the crime. Thus, for a contravention of the insider dealing prohibition, the insider does not even need to have that 'factual' connection with the company which is required for a disqualification order.

The fact that the person who contravenes the insider prohibition is not a

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1301 [1994] 1 BCLC at 349.

1302 My emphasis.

1303 Cf 'Disconnecting insiders'-Comment, 15 Comp Lawy 1994 at 130. The author of the comment hopes that the decision by the Court of Appeal will remain good law.

1304 R v Goodman, [1994] 1 BCLC 349.

director (or some other 'classical insider'), did not preclude the 1986 Disqualification Act from applying to him. On the other hand, if the CDA is applicable to directors in general, why should it not be applicable where the director is sentenced under the insider legislation? The new law brought about an extension of the insider-definition, not a narrowing of the CDA.

Disqualifications for insiders raise the question of the conceptual basis of the prohibition. The rationale of the new law in England (and in Germany) is the protection of the market, and much less, if at all, the protection of the company. Thus, arguably, there is no justification to exclude an insider from management tasks only because he contravened the insider provisions. At the very least, the particular sanction imposed in the Goodman case seems disproportionate because Mr Goodman was excluded for 10 years from professional duties. After all, the question whether or not insider trading is beneficial, remains unanswered.

The intention of the Disqualification Act is to protect companies and not to punish insiders. Mr Goodman' s breach of the law has been atoned for after his 18 months´ imprisonment,[1305] and there was no need to keep him away from his profession for so much longer. The market is protected well enough when Mr Goodman is prohibited from trading in it. We should agree to such a ruling only in cases of serious crimes (eg selling weapons to a crisis area) where the convicted person is found to be morally unworthy of representing a company's management. With regard to insider trading, on the other hand, it is not even certain whether such trading is socially harmful. As far as deterrence is concerned the Goodman decision may prove quite efficient, but it does not seem to be fair and equitable.

A Model provision ought to provide for disqualification orders only if the majority of the monitored companies desire this sanction. The reason for this is that such disqualifications reflect a good deal of company protection. It is also suggested that the disqualification should not exceed 3 years (excluding the time of imprisonment).

An optimal sanction equals the harm (eg a fine), properly increased for the chance of not being detected, plus the variable enforcement cost of

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[1305] 9 Months served and the balance was suspended, see R v Goodman [1994] 2 BCLC 349 at 350.

imposing the fine.[1306] As far as insider trading is concerned, we certainly have a low probability of detection. It is therefore necessary to increase the maximum sanction in order to make up for the inefficient detection.

The lawyer must also take into consideration certain general legal principles. What might appear acceptable from a purely economic view, need not necessarily be acceptable for a legal provision. It is suggested that the principle of proportion sets a limitation on the severity of both fine and imprisonment. The South African legislation has taken things rather far. Imprisonment for a maximum period of 10 years is imposed for kidnapping or sometimes for homicide.[1307] This is a gross exaggeration as far as insider trading is concerned, however central the role of the protected capital market might be.

It does not seem acceptable to put a limit to the fine (eg in the South African law), given that sometimes the gains from insider trading are extremely high.[1308] In cases where the profits are so immense that even the maximum fine which is conceived as a 'ceiling', would not create an appropriate sanction, the courts could still impose imprisonment. This, however, would mean a loss of flexibility. It is suggested that no ceiling be put on the fine, but that provisions should be made for a fine which may be up to three times as high as the gains which the insider realised. This is also a sufficient deterrent. A weakness of this approach is that in situations where the insider encourages others to deal or discloses the information the courts would lack a parameter that would help determine a proportionate fine. Since the person who passes on the information cannot foresee how much the actual dealer gains, there should be a ceiling fine for such cases.

Another alternative would be to impose fines, as like under the German StGB, which are proportionate both to the severity of the criminal act and the personal financial situation of the wrongdoer. An example of this is a case where a fine is imposed which is equivalent to the income which the convicted normally earns in the space of 180 days.

1306 Polinsky and Shavell, 'Enforcement costs and the optimal magnitude and probability of fines', (1992) 35 Journal of Law and Economy at 133.

1307 Still, the King Report op cit at 31 suggests that the maximum statutory sanction should be imprisonment from two to ten years. That seems exaggerated.

1308 Jooste op cit at 599.

A Model Code ought to provide that money obtained through committing the offence be retained by the prosecuting authorities. These gains should in turn be used to finance the public body which monitors the stock exchange.

Certain authors[1309] have suggested that a duty be imposed on every manager and director to report all buyings and sellings in their companies´ shares. This, of course, is not a sanction, but a Model Code may still provide for a sanction in case the duty is not fulfilled. Yet there is no evidence whatsoever that such reporting duties actually deter insider trading.[1310] The lack of empirical evidence in support of the suggestion is not surprising. If one considers early attempts to combat insider dealing (eg in the English and South African law) it becomes obvious that such reporting duties are not an effective preventative measure. Insiders can always act through third parties and thus escape those reporting duties.

Having examined both economic and legal aspects of insider trading, it is now time to put the pieces together and make suggestions for a Model Code which incorporates modern economic theory as well as the results of the legal analysis in Part Two of the present study.

1309 For the point of view of a German economist see Schneider op cit (Wider Insiderhandelsverbot) at 1435.

1310 Schörner op cit at 181 et seq.

Chapter III: Suggestions for a Model Code

The following suggestions for a Model Code incorporate the findings from both economic analysis and comparative examination. Our intention is to combine regulatory and de-regulatory aspects, thus opening up a pluralistic approach to insider trading. Technically, there is also the question of where the insider trading legislation should be contained. Since it is suggested to base an Insider Code on the market protection approach, the provisions should rather not be contained within the Companies Act. Also, it should be made clear that the prohibition not only relates to shares, but also to other financial instruments.[1311] It is, however, not necessary to enact a separate 'Insider Trading Act', but it would be sufficient to include the relevant provisions in the Stock Exchange Act.

I. Suggestions for the preamble to a Model Code

Firstly, the preamble to a Model Code ought to say something about the economic uncertainty that still prevails in insider trading. It is suggested that the preamble should make it clear that the law needs to accept this uncertainty and grant several options for companies. It should also be mentioned that the law needs to be reviewed as soon as new empirical data about the economic pros and cons of insider trading becomes available. The options granted by the Code should be that companies can either allow or disallow their insiders to trade. This means that firms can 'opt out' of the legal prohibition. If they do, their shares will not be monitored for insider activities. Insider trading is no longer prohibited per se.

Surely firms can also 'opt in' which means that their insiders commit an offence when trading on non-public information. The prohibition is intended to enhance the functioning of securities markets (market protection approach). The prohibitions therefore apply to transactions only when these are effected in impersonal and regulated markets. When such trades are effected on the account of a juristic person, the individuals who acted on behalf of this juristic person shall be liable. Face-to-face transactions do not fall under this regime.

Secondly, the preamble ought to give some guidance with regard to the

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1311 See King Task Group Report op cit at 43.

definition of the insider. This definition must be in line with the intention to protect the market. One should take into account that persons, even though they may have been in possession of inside information, cannot commit the insider dealing offence when they do not owe any duties for the functioning of the market. Only people with duties of that kind should be regarded as insiders by the courts. It is suggested that the Courts must establish that the effected transaction was likely to cause harm to the market. If there was no possible damage to the market the public good which the law intends to protect was in no danger. Hence no offence is committed.

II. Suggestions for individual provisions

Deregulation

Above all, a Model Code should clarify that shares are monitored only when companies apply to the supervisory body of the Stock Exchange for monitoring, and pay a certain fee towards this service.

To this effect a Model Code ought to allow companies to 'opt out' of the prohibition of insider trading. Insiders would then be allowed to deal on the strength of inside information or sell the information. It is suggested that companies should be required to insert their decision in the articles of incorporation. It is also suggested that there ought to be some contractual agreement between the company and its directors, managers, or other high-ranked employees. It should be provided in these contractual agreements that the insider is allowed to deal on inside information in exchange for a reduction in his managerial remuneration. It is also suggested that such contracts should provide that insiders are prohibited to sell stock or go short in the shares of their company (ie enter into a sale where they do not yet possess the stock) ahead of bad news.

Companies have to inform the Stock Exchange supervisory body of these contractual agreements. The securities issued by those companies are not monitored for reasons of insider dealing. If those companies wish their securities to be monitored on behalf of information exogenous to the company, they must contribute to the monitoring costs according to a payment scheme which should be developed by the Stock Exchange.

The Offence

A Model Code ought to define the offence in a clear way. It is suggested that any person who is in possession of inside information or has knowledge of a recommendation which is based on inside information is guilty of an offence, if he discloses the information or the recommendation or deals in any security, right, option, contract, or derivative that may be affected by the information. The definition ought to be broad in that it assumes a link of causality between having the information and committing the offence. This makes it necessary on the other hand to limit the scope of inside information to major events.

The term 'deal' ought to be broad enough to cover all forms of indirect trading, too. A Model Code should therefore provide that a person 'deals' when he, either himself or through any other person who acts on his behalf, acquires or disposes of securities, rights, options or derivatives, or enters into a contract which creates a right or a security or a derivative, or brings to an end such a right or contract or derivative.

It is also suggested that a person should be held guilty of an offence if he recommends or procures any other person to deal, or disclose, or recommend to another person that he deal, disclose, or recommend, before that information is published in accordance with the publishing requirements.

New information is incorporated in the share price on all international markets once it has been published in one country. It is therefore suggested that the insider does not commit an offence if the information has been published in accordance with the publishing requirements of a market in another country prior to his dealing.

Given the importance of certain market activities for the functioning of the market it is suggested that a person does not commit an offence if his trading is effected in the proper performance of his professional duties, in his function as a market maker, or in the pursuit of monetary or other policies on behalf of a public sector body.

Inside Information

Following on from our analysis, a Model Code should not try to define inside information in purely abstract terms. Instead, it is suggested that information is relevant for the insider trading prohibition when it appears on a list provided in the Act. At the risk of not catching some insider traders because the information they use is not (yet) on the list, the gain will be much more security concerning the scope of the offence.

A Model Code ought to include at least information about the following facts, events, undertakings, and organisational measurements:

Company Information:

- Take-overs; fusions; mergers; forthcoming offers and bids in relation to take-overs, fusions or mergers; management buy-outs;
- Changes in the share capital of a company; resale of shares;
- Earning announcements; substantial strikes in mineral ore; contracts which substantially increase or decrease the earning power of the company, or the ending of such contracts; new product lines.

Market Information:

- Change in taxes imposed on companies;
- Embargo or lift of embargo on products of a company or companies (the latter being sectoral market information;
- Change in the general interest rate by the Federal Reserve Bank;
- Recommendations to sell or buy securities even if such recommendations are based exclusively on public data.
- Identity of traders and trade volumes on securities markets.

It is suggested that, where the word 'substantial' is used in connection with earning power of a company it should mean 3% or more. In cases where the percentage is smaller the burden ought to be on the prosecution to establish that the insider nevertheless acted on the basis of the information.

Surely economic research will reveal in future that other types of information are also relevant for the prohibition. A Model Code ought to provide for a potential enlargement of the above list. When empirical evidence is furnished that another type of information does usually change investors´ expectations, the Minister should be allowed to add this type of information to the list.

Defences

We have seen that some market activities such as trades by market makers in the normal course of their professional transactions ought to be exempted. Yet economic theory has shown that some other insider transactions do not harm the functioning of the market either. A Model Code should therefore provide some further defences. It is suggested that the accused ought to prove the existence of special circumstances that give rise to such a defence on the balance of probabilities.

A person should not be guilty of an offence if he had no connection to the market. Such a connection may also be absent in situations where the person does neither act in his national market nor recommends to trade in it. A person should also not be guilty of an offence if he did not act on the strength of inside information, although he was aware of it.

We have seen that the element of substantiality is difficult to define. A Model Code ought to take this into account and provide a defence in cases where the accused can prove that he did reasonably believe that the information was not price relevant. A Model Code could, for instance, formulate that 'a person is not guilty of an offence, if, although the substantiality requirement of the information is met, the insider had reasonable cause to believe that the event was nonetheless not likely to cause a change in investors' expectations about the assets of the company'.

One of the most important lessons to learn from economic theory is that, due to secondarily informed trading, the price impact of the information can happen long before the information is actually published. If the price potential of the information has been used before the insider trades, there is no reason to punish the insider, because he cannot harm the functioning of the market. Thus a Model Code ought to provide that a person is not guilty of an offence, if, at the time of the alleged dealing or disclosing the potential price impact of the information was already reflected in the price of the security.

Sanctions

Our study has shown that it can be useful to combine imprisonment and fines in order to create a deterrent effect. We have also seen that, if the sanction is a fine, this fine must be in proportion to the gain the insider has made. A Model Code ought to provide that a person convicted of the trading offence is sentenced to a fine not exceeding three times the amount of the profit which resulted from the offence, or to imprisonment not exceeding a period of three years of imprisonment, or both.

Moreover, a Model Code ought to take into consideration some general principles of how to apply sanctions. It should provide that the Courts must take into account the severity of the offence, the profit which resulted from the offence, and also the financial situation of the convicted.

Last not least a Model Code ought to take into account that insider trades on Stock Exchanges represent only a small part of the daily turnover. In order not to affect the rest of the trades, it is suggested that no transaction on the Stock Exchange should be void or voidable by reason only of the fact that it was based on inside information.

Supervision

A Model Code ought to address the issues of supervision and detection. It is suggested that the supervisory body of the Stock Exchange should develop a set of rules concerning detection devices with regard to insider trading. These rules ougth to provide that all trading activites in securities of an issuer must be examined after important information has been published, unless companies have informed the authorities of their choice not to have their shares monitored.

The supervisory body of the Stock Exchange ought to develop within three months of the coming into force of the provisions a payment scheme according to which companies that wish their shares to be monitored pay fees for the monitoring services. The payment scheme ought to take into account the number of shares of a company which are regularly traded, the number of presumed insiders in that company, the volatility of the share or option prices of that company; the branch of industry; the occurance of insider trading in the securities of the issuer, and the average frequency of exploitable inside information.

Summary

This thesis has pursued the idea that insider trading is not a problem of 'fairness', but instead one of efficiency on securities markets. There is no convincing economic model which accurately explains whether insider trading causes benefits or losses to investors. Any fairness approach to insider dealing ought therefore to be discarded.

Indeed, given the economic uncertainty surrounding insider dealing, it is unclear whether insider trading restrictions should be imposed at all. Economically, there is neither evidence that insiders outperform the market, nor that they cause harm to individual investors. Their trades do not result in price changes, because demand curves on stock markets are elastic. If there is price movement, it is caused by 'signalled' trading. Signals (ie price, volume of trades by insiders, and their identity) are decoded by other traders which helps incorporate new information into prices before announcement. From this perspective insider trading can be beneficial for the allocative functions of the market.

We have seen that it is not self evident that insider trading is immoral. It could even be argued that insider trading is moral, if it fosters market efficiency. It has therefore been suggested that insider trading prohibitions should not be based on the alleged immorality of such trading.

Insider trading does, however, involve some redistributional effects of wealth. The economic analysis yielded the conclusion that it is uncertain whether or not regulation of insider trading is beneficial for the parties involved in the redistributional process. Several economic theories suggest that deregulation would indeed be better. Based on these findings a 'democratic market approach' was suggested which combines both regulation (monitoring) and de-regulation (companies may opt out and allow their insiders to trade).

It was suggested that the law should allow firms to opt out of the regulatory system, allowing their shareholders and insiders to redefine the distributional effects of insider trading within the contractual nexus of the company. This agency approach ought to be permitted by the law because it allows principals (ie shareholders) and their agents (ie the management) to negotiate their interests in each individual company. That would help reduce transaction costs (eg for monitoring) and bring conflicting interests into balance.

Economic research also evidences that insider trading helps to reflect information more accurately in prices, and thus enhances the efficiency of the pricing in securities markets. Given that monitoring insider activities is costly, it does not seem indispensable to restrict such trading. Instead, the law could rely on the effectiveness of contractual relations between shareholders and managers allowing the latter to trade on inside information in exchange for a reduction in salary. It has also been suggested that, given a residual risk-averseness on the part of the managerial staff, it is advisable to agree on a reduction in salary which does not equal the expected gains from insider trading. It was argued that these contracts can result in a more appropriate redistribution of wealth, because the actual producers of valuable information would profit from trading, rather than the securities industry people.

It was submitted that, although some commentators think it might be difficult to determine the exact amount of such a reduction in rewards, this problem is best left open to negotiation between the parties involved. It was, however, found to be preferable to allow insider trading only on strength of positive information. This would seem to be necessary in order to prevent moral hazard problems.

It was argued that at present insider dealing prohibitions serve the interests of people working in the securities markets industry, particularly in England, but also in Germany, though to a lesser extent. Shareholders should recognise that they can be outperformed by market professionals, and not only by classical insiders. Instead of moulding provisions in the interests of a certain groups, all interests should be balanced. To this effect private negotiation should be allowed in order to establish the real preferences of shareholders, companies, and management.

If shareholders do not wish that their firms 'opt out', the law should prohibit only well defined situations in which informational imbalances are exploited by persons who owe some kind of duty to the securities markets.

It was further suggested that companies which prefer their shares to be monitored for insider trading should be required to pay for this monitoring service. Since we do not know whether insider trading is detrimental, it is inappropriate to make the taxpayer pay for this type of transaction costs.

In order to better understand the legal implications of insider trading, three laws were examined at length, namely the South African, the English and the German insider laws. Their provisions are in some ways representative for the present situation in most countries where insider dealing is debated. It was found that restrictions placed on insider trading are based on the semi-strong form of the hypothesis of informationally efficient markets ie that only published information is reflected in the share price. This hypothesis is, however, contestable. Thus even the basis of the regulation is uncertain. This adds to the economic doubts.

It was argued that it would be best to provide a legal solution which takes into account both regulation and de-regulation. This method would grant the greatest number of alternatives to market participants. Hence prohibitions still need to be formulated.

Thus it is still necessary to determine the best possible definitions for insider trading prohibitions. The examination turned to the components of the three insider trading laws. It was found that, with regard to the key element of 'inside information', all prohibitions place restrictions only on dealings ahead of major events. This legal approach seems to be based on the hypothesis that both outsiders and the market are harmed only where insider profits are high and obvious. For this purpose, all three laws limit the prohibition, in one way or another, to 'material' information.

However, the formulations used eg 'likely to materially affect prices' are likely to create much uncertainty amongst investors. Many suggestions for a more precise determination of 'material' have been made in Germany, where the doctrine of the 'objective wording' places a limit on the interpretation of penal law statutes. The only thing of which we can be certain is that, economically, it is erroneous to try to determine 'materiality' according to actual price shifts that occur on release of the information. It was submittted that the correct approach is to list certain major events, including some market information (not encompassed by the current South African law). It was recommended that the South African prohibition should be extended in this respect. It was also suggested that trading should be restricted only where it can be established that the trader is in possession of listed information.

In terms of the 'market protection' approach, the definition of inside information should be narrowed so as to include only few very important items of company and market information. This would also reflect economic theory which demands clear-cut definition in order to grant maximum freedom.

Another problem was to determine when the relevant information becomes 'public'. In this respect the examined laws were found to differ considerably. In South Africa, the moment when information becomes public is particularly uncertain. This leads to economically harmful results. Either important investors abstain from trading because of possible allegations of insider trading, with the result that the market's liquidity is reduced, or, traders act quickly and avail themselves of general or special defences.

The English law provides a great number of such defences. It was found that these defences, (as well as the debatable provision of many exceptional circumstances under which information 'may' be treated as public), reveal that the law was moulded under influences which originated, not from the legislator, but from the financial services industry. Given that all public information is almost instantaneously reflected in prices, there is no need for an extra 'digestion' time as provided by the South African law. Such extra time is a vain attempt to maintain the now discarded approach of small investor protection.

It was suggested that information ought to be regarded as 'public' as soon as it is published according to the publication requirements, or when it becomes available on the Stock Exchange via ticker tape. No extra time for the information to be absorbed by market participants should be given.

It was further argued that other additional elements in the definition of information such as 'specific' (in England) or 'precise' (in the European Directive) are superfluous. They should be discarded.

'Investor protection' was evaluated as a conceptual basis to insider dealing regulation. The main issue for which a conceptual basis became relevant was the question of how to define the insider. It was suggested that the current provisions defining insiders are altogether defective. All three examined laws have discarded the fiduciary approach which defined the insider by means of his connection with a company. It was submitted that this is correct because many people other than company insiders are likely to trade on inside information, and most of these people are not bound by fiduciary duties eg bankers, advisors or lawyers.

Yet no new criterion has so far been introduced to replace the old approach. It was suggested that the courts should be given discretion to develop certain criteria, such as 'market responsibility', which would help determine whether a person should be convicted. In general, any person who is in possession of information contained in the submitted list, should be regarded as a potential insider. The law should, however, grant the courts sufficient discretion to develop through case law the notion of 'market duty'. A person who has no duties towards the market cannot cause harm, because he cannot regularly outperform other market participants (eg someone who coincidentally overhears a conversation between two executives). Such persons should therefore not be convicted as insiders. If they steal information on someone else's behalf (or pass the information on to an insider) they should rather be held liable for aiding and abetting.

It was further suggested that the issue of 'tipees' is not properly addressed by the three laws. Either counselling is not banned (in South Africa), or the recipient of a tip can freely trade because the law requires that he must be in possession of the information itself (in England and Germany). Economically, however, tipee-trading was found to be one of the crucial issues. If insiders trade, the process of reflecting information in prices is enhanced through derivatively informed trading. Tipees, however, do not convey as much trading information to the market. Their trading is therefore less beneficial than trading by 'real' insiders. If restrictions are to be imposed, they should address tipee dealing in particular.

Next, the issue of defences was dealt with. It was found that defences need be available only in situations where the insider did not intend to exploit informational imbalances, which was found to be the actus reus of the crime. The insider may also avail himself of some general defences, for instance, that he did not act on the strength of information (which should normally be inferred from the fact that he traded while in possession of the relevant information). It was submitted that market makers should be exempted. There is, however, no need to create many sophisticated defences in order to deepen pre-existing redistributional errors.

Finally, the question of appropriate sanctions was considered. It was suggested that the appropriate sanction is a criminal one, which may be accompanied by a disqualification from certain business functions. It was, however, argued that it is pointless to provide civil remedies against insiders. Sanctions should be imposed equally on source insiders and recipients of information, because secondarily informed ('tipee') trading does not convey sufficient trading information to other investors, and thus results in weaker price efficiency than trading effected by primary insiders.

Given that market protection, allocation of capital, and the pricing of stock are public goods, and given that insider dealing as such probably causes no harm to individual investors, the only sanction which seems appropriate is the criminal sanction. It was submitted that the civil remedy created by the South African law is a wrong way of trying to cope with insider trading. It is also very unlikely that a civil court would unveil[1312] indictable offences which have been committed, if they have neither been detected by the stock exchange supervisory body nor by the public prosecutor. The onus of proof is lighter in civil law. But, since probably no investor is individually harmed when he trades with an insider, the lighter onus of proof does not really help and is therefore of no practical significance.

Provided that the principle of proportionality is respected with regard to the period of disqualification, the criminal sanction could be accompanied by a disqualification order where the convicted is a director or a manager of a company. The English case law reveals that such sanctions are likely to contribute to the deterrent effect. Here again we should bear in mind that, at the current stage, the economic basis of insider trading is uncertain. It was therefore suggested that sanctions, especially imprisonment and disqualifications, should be imposed with great care.

Having considered both economic and legal implications, and having based them on a new democratic approach towards insider trading, suggestions were made for a Model Code.

1312 See, however, for an improved system of information-gathering in civil procedures Khama, 'Corporate criminal liability: What purpose does it serve?', Harvard Law Review, May 1996, vol 109, 1477 at 1520.