Core Issues of Regulating Insider Trading - A Comparative Analysis of US, EU and Moldovan Law

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TABLE OF CONTENTS

ABSTRACT

The ultimate purpose of this paper is to provide an assessment of the core elements of modern insider trading regulations and to compare their implementation under the Moldovan law. Thus, the paper provides an overview of the insider trading regulations according to two major models - the EU and US models, focusing on the main elements of the insider trading prohibition, definitions of insiders, inside information. This paper analyzes the same elements under the Moldovan law and examines the implications of these legislative provisions. It shows that the current wording of insider trading regulation under Moldovan law is not in line with modern models of insider trading regulations and this ultimately hampers the activity of the market.

INTRODUCTION

A few legal concepts could claim so much notoriety and, at the same time, so much opaqueness for the public as the term insider trading. Neither the notion itself, nor the broad context of capital markets where this phenomenon occurs, nor its eventual consequences and implications are familiar enough to the public to generate an unequivocal opinion on insider trading. In addition, even if viewed as harmful, insider trading is somehow derivative of other "primary sins", such as theft (or misappropriation) of information and cheating. This ambiguity and the somehow secondary nature of this phenomenon lead to the conclusion that insider trading is not a "malum per se", it is not "wrong in itself, in its very nature being illegal because it violates the natural, moral, or public principles of a civilized society"[1]. Rather, it becomes a "malum prohibitum", only insofar as the state decides to ban insider trading practices. Hence, the economical implications of this phenomenon have to be thoroughly analyzed, before any legal regime concerning insider trading will be established. The importance of an economical analysis of a regulation is justified by the words of Milton Friedman, who claimed that "…differences about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action – differences that in principle can be eliminated by the progress of positive economics – rather than from fundamental differences in basic values, differences about which men can ultimately only fight"[2].

This paper will proceed with an analysis of the policy debate over the need to regulate insider trading. It will offer a brief overview of the company-related dimensions as well as market-related dimensions of insider trading. It will be shown that, despite all the alleged benefits of insider trading, it is ultimately detrimental both for the particular company and for

[1] Legal Dictionary, available at http://legal-dictionary.thefreedictionary.com/malum+in+se
[2] R.H. COASE ESSAYS ON ECONOMICS AND ECONOMISTS 47 (THE UNIVERSITY OF CHICAGO PRESS, 1994).

the market as a whole. Further, the paper will analyze two major models of insider trading regulation: the US model and the EU model. It will focus on the main elements of the insider trading prohibition, definitions of insiders, inside information. The ultimate purpose of this analysis is to assess the core elements of modern insider trading regulations and to compare their implementation under the Moldovan law. Thus, the paper will provide an overview of the insider trading regulation under the Moldovan law and will examine the implications of these legislative provisions. It will be shown, that the current wording of insider trading regulation under Moldovan law hampers the activity of the market.

1. POLICY DEBATE OVER THE NEED TO REGULATE INSIDER TRADING

1.1. Introductory Note

Although a relatively new concept in the legal theory, insider trading has already generated numerous fierce debates revolving around one major issue: is insider trading harmful to the society so that to justify its inclusion in the broad category of "malum prohibitum" or, to put it differently, to justify its regulation by the state? The parties to this debate have used different criteria. At the initial stage, the debate was focused on principles of fairness and equity, the main issue being whether insider trading is unfair to public investors who are not in the possession of private corporate information[3]. This criterion proved to be "malleable, lacked a rigorous theoretical framework, and therefore did not yield coherent or practical policy prescriptions"[4]. Moreover, an efficient market regulation needs to be based on something more than equity and fairness. One should not confuse the means with the aim. Without diminishing the importance of these principles for any economical system, I perceive equity and fairness as the concepts that describe the *modus operandi* of the market; these are the underlying principles of any legal rule, but they should not be the substitutes for the goal of an efficient economic regulation. Thus, a regulation is being designed bearing in mind the ultimate goal it has to achieve, while equity and fairness are the attributes of the means and tools applied in achieving this purpose. What would then be the ultimate goal to be achieved by regulating insider trading?

Here we switch to the concept of economic efficiency, brought into the stage by Henry Manne in his 1966 book, "Insider Trading and the Stock Market". Professor Manne argued

[3] Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate* 239 (last visited Feb. 20, 2008) <http://www.law.umich.edu/centersandprograms/olin/papers.htm>
[4] *Id.* at 239

that insider trading is economically efficient and, thus, should not be prohibited by the state. Manne's thesis "abruptly shifted the focus from fairness to the economics of insider trading and precipitated an intense debate in the law and economics literature about the efficiency implications of insider trading"[5]. The vague and somehow declarative criterion of fairness was replaced by the seemingly accurate, precise, and measurable criterion of economic efficiency. Nevertheless, this criterion did not yield a single outcome and consensus among scholars and practitioners as regards the need to regulate insider trading. Even more, the real controversy only began with the introduction of the economic efficiency criterion in the policy debate on insider trading.

The benefits and disadvantages of insider trading regulation are generally analyzed at the firm[6] level and at the market level. At the firm level, the so-called agency theories of insider trading analyze its effect on the manager-shareholder relationship. Agency theories examine the implications of insider trading on the manager-shareholder conflict of interest and according to the results it is argued that insider trading increases or reduces efficiency on the firm level. At the market level, the overall market efficiency of insider trading is being analyzed, including its impact on stock prices accuracy and stock market liquidity. According to the outcome of these analyses, the parties to the debate are divided into proponents of insider trading regulation and advocates of a deregulated insider trading activity. A distinct group of scholars opts for a private regulation of insider trading activity, which is regulation on the firm level through the means of a contract concluded between interested parties, instead of state regulation. I shall briefly analyze all these theories in the following chapter.

[5] *See id.*
[6] Further on, the terms "firm" and "company" will be used interchangeably.

1.2. Agency Theories of Insider Trading

1.2.1. Insider Trading as a Compensation Mechanism

In his book "Insider Trading and the Stock Market", Henry Manne argues that "insider trading by top management is an essential incentive for entrepreneurs"[7]. As the managers are usually conservative and avoid engaging in riskier projects, for job security reasons, the company might miss many valuable business opportunities. A sound management compensation scheme could be one efficient stimulus for them to embark on riskier projects, yielding bigger profits for the company. According to Carlton and Fischel, "If a manager observes a possible valuable investment for the firm – such as a potential value–increasing merger or a possible new technology – he will be more inclined to pursue this opportunity if he is rewarded upon success. Insider trading is one such reward"[8]. The legitimate question stemming from this affirmation is the following - why would it necessarily be insider trading the best reward? Why can't a proper amount of compensation for managers or, in a broader context, entrepreneurs, be established by the means of private negotiations with the company? According to Manne, the just amount of compensation for the entrepreneurs cannot be determined in advance. It happens for a number of reasons. First, the entrepreneurs themselves cannot be identified in advance. Almost any employee or shareholder of the company can generate innovative and valuable ideas. Second, the value of the entrepreneurial innovation cannot be estimated beforehand. As Manne puts it, "True innovation cannot be predicted nor its value known before it has been thought of and made effective. True innovation cannot be planned and budgeted in advance. An individual cannot be hired to perform *x* amount of entrepreneurial service"[9]. Thus, providing *ex ante* in the employment contract the amount of compensation for entrepreneurship is usually inefficient and

[7] WILLIAM K. S. WANG & MARC I. STEINBERG, INSIDER TRADING 14 (Aspen Law & Business, 1996).
[8] *Id.* at 16
[9] Beny, *supra* note 2, at 242.

imprecise. *Ex post* renegotiations of the compensation clauses could be required, but this is not the best solution. If the entrepreneur would be allowed to trade on her innovation, this would amount to a fair and just reward for the innovation. The entrepreneur could buy the shares of the XYZ company at the Q market price, before the news of the innovation reaches the market. When the market learns the good news, the XYZ shares' price goes up and the entrepreneur would be able to sell these shares at the W market price, which is higher than Q. The profit thus made represents the entrepreneur's compensation for her innovation. One could argue that such a scheme benefits only wealthy entrepreneurs, those who can afford themselves to dispose freely of large amounts of money in order to buy shares in an expedient manner, before the news reaches the public. Nevertheless, this scheme works even for the poorer ones, as these could "sell" the information to others. Such a compensation scheme allows for more accurate and rapid compensations, than the costly, cumbersome, time - consuming and frequently unjust *ex post* renegotiations of the employment contract.

Because of the abovementioned, insider trading allows the firm to exploit at a maximum the entrepreneurial spirit of its employees without incurring any of the potential costs related to estimations of the level of compensation in advance, observance of the effort and output in order to renegotiate the compensation previously agreed on and many others.

Carlton and Fischel indicate another valuable effect of insider trading which benefits both the firm and the labor market. "A related advantage of insider trading is that it provides firms with valuable information concerning prospective managers. It is difficult for firms to identify those prospective managers who will work hard and not be overly risk averse in their choice of investment projects. Basing compensation in part on insider trading is one method for sorting superior from inferior managers. Because insider trading rewards those managers who create valuable information and are willing to take risks, managers who most prefer such compensation schemes may be those who are the least risk averse and the most capable"[10]. Assuming that insider trading is regulated at the firm's level, managers would "self – select into firms that allow it, insider trading reduces both screening and monitoring costs. Lower screening and monitoring costs imply lower agency costs, a central concern of corporate law"[11].

Finally, it has been argued that insider trading regulation enhances agency problems by discouraging active shareholding and, thereby, distorting the system of corporate governance[12]. Large shareholders usually tend to be active, as because of their larger investments they bear more risks and costs than minority shareholders do. Thus, they have a direct and immediate interest in monitoring the performance of the company. Large shareholders hold chairs in the Board; they have access to multifarious types of internal information, hence being able to assess more accurately the performance of the executive body and exercise influence over the latter. Therefore, active shareholding, usually exercised by large shareholders, reduces agency costs and enhances the overall value of the firm[13]. Allowing controlling shareholders to trade on the inside information they possess represents a compensation for the additional risk assumed by such shareholders by not being well diversified[14].

The regulation of insider trading imposes additional burdens on large shareholders and often places them in a disadvantageous position as compared to minority shareholders. For example, in the US, under the Securities Exchange Act of 1934, owners of more than 10% of equity are considered insiders and they have to report all their trades in equity securities on a monthly basis; they are also prohibited from trading when the purpose is to realize short-term

[10] *Id.*at 243.
[11] *Id.*
[12] Alexandre Padilla, *The Regulation of Insider Trading as an Agency Problem* 23 (last visited Feb. 21, 2008) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=632842>.
[13] *Id.*
[14] Henry Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark* 3 (last visited March 2, 2008) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=679662>.

profits, which are profits resulting from the purchase and sale of securities in a six-month period (with several exceptions); insiders are also prohibited from short sales. All these liabilities and restrictions lead to the investors' reluctance to hold large block of shares above the 10% level that triggers the insider status. This finding seems to be in line with the findings of a study performed by Laura N. Benny in 2006 on the basis of data from a cross-section of thirty-three countries. According to the results of the study, "countries with tougher insider trading laws have more outside ownership (greater ownership dispersion). Conversely, countries with weaker insider trading laws have more concentrated ownership"[15]. Accordingly, it was held that "insider-trading laws deprive the shareholders of the important governance mechanism that inside monitoring is"[16].

To summarize, the alleged benefits for the company of unregulated insider trading are the following:

- Insider trading provides an efficient compensation device for entrepreneurs/managers;
- Insider trading stimulates entrepreneurship;
- Insider trading reduces monitoring costs, due to the indirect relationship between stock ownership concentration and the level of insider trading regulation.

1.2.2. Insider Trading as an Agency Cost

The efficiency of insider trading as a compensation device has been questioned by many scholars and practitioners[17]. It is interesting to note that Henry Manne himself doubted this alleged benefit of insider trading, after almost 40 years since he first advocated insider trading: "My second "positive" argument for insider trading, that it could perform well as a

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[15] Beny, *supra* note 2, at 262.
[16] Padilla, *supra* note 10, at 26.
[17] See, for example, Stephen M. Bainbridge, *Insider Trading* (last visited March 1, 2008) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=132529 >;

part of an executive compensation package, has been the more forcefully attacked, and it is perhaps less robust than I and other proponents had originally assumed"[18].

The main problem with insider trading as a compensation mechanism is that it distorts compensation schemes, which relate payment to productivity. In order to make an efficient assessment of the management's input and the related payment generated by insider trading, firms might have to monitor manager's trading *ex post.* All insider trading by managers, their tippees (the persons to whom they passed the inside information in return for a benefit) and subtippees has to be somehow reported to the firm, making possible the monitoring of the compensation level of its executives. This cannot lead to anything else but supplementary costs incurred by the firm. Moreover, it happens very often that those who produce innovations and generate entrepreneurship are not the only ones who benefit from their input. As ascertained by Henry Manne, "valuable information will undoubtedly get into the hands of individuals inside and outside the company who in no sense should be compensated, usually because they will have done nothing to produce the valuable new information"[19]. This free-rider problem might lead to "information hoarding within the firm, as the true entrepreneurs, who are the real innovators in the firm, would have an incentive to hold their information close to their chests to maintain a monopoly on insider trading profits"[20]. The free flow of information within the firm is impaired and the firm's overall efficiency is diminished.

Another major problem is that insider trading might provide incentives for the managers to engage in excessively risky projects. If they can trade on the news, be it good news or bad news, they would have a direct interest in striking new opportunities, no matter how dangerous or risky they are for the firm. Even more - the riskier the project is - the better outcome for the managers. Ultimately, they will not be interested in the overall performance

[18] Manne, *supra* note 12, at 5.
[19] *Id*. at 9.
[20] Beny, *supra* note 2, at 244.

of the firm, as they will receive their compensation from insider trading activities regardless of whether the firm is doing well or poorly. If managers are permitted to sell shares short, this worsens the situation. In a rudimentary short sale scheme, A borrows N shares of the XYZ Company from B and sells them at P1 market price. When the time comes to return N XYZ shares to B, A has to buy them at the P2 market price. Such a scheme can't be efficient unless P2 is lower than P1. Therefore, A is directly interested in a decline of the XYZ shares market price. Her gains are directly proportional to the value of the decline. Now imagine a high-level executive of a company being allowed to trade on inside information and deciding to speculate on the bear side of the capital market. She sells her company's shares at a high price and she is highly interested in seeing the market price of these shares plummeting, in order to be able to purchase them as cheap as possible and give them back to the lender. Her position within the company allows her to take decisions of a crucial importance for the company and leading, as a result, to variations of the company's shares market price. The worse for the company are decisions taken by him, the better off he will be. A colorful example is given by Professor Klock, as quoted by Laura N. Beny:

"Mr. Wiggin was the head of Chase, the nation's second largest bank at the time. In July 1929 Mr. Wiggin became apprehensive about the dizzy heights to which stocks had climbed and no longer felt comfortable speculating on the bull side of the market…Believing that the prospects of his own bank stock were particularly dim…he sold short over 42 000 shares of Chase stock…Wiggin's timing was perfect. Immediately after the short sale the price of Chase stock began to fall, and when the crush came in the fall the stock dropped precipitously. When the account was closed in November, Mr. Wiggin had netted a multimillion dollar profit from this operation.

There are two possible interpretations of the Wiggin case. One is that Mr. Wiggin believed bad news was inevitable and sold short. He then worked vigorously against his own self interest trying to minimize his profit, and even trying to lose his personal wealth, but nevertheless managed to make a great deal of money in spite of his best efforts to the contrary…The alternative was that there is some self-dealing going on. Readers are left to determine for themselves the more probable explanation”[21].

[21] Beny, *supra* note 2, at 245.

1.3 Market Theories of Insider Trading

1.3.1. Insider Trading and Stock Prices Accuracy

The implications of insider trading should not be confined to the boundaries of the firm. While the abovementioned agency theories cannot be neglected, I think that the public's main attention was triggered to insider trading due to its effects on the market as a whole and, ultimately, on the economic growth. One of the main arguments in favor of unregulated insider trading was its alleged beneficial effect on stock price accuracy. According to Henry Manne, "there is almost no disagreement that insider trading does always push the price of a stock in the correct direction"[22]. The "correct direction" would be one which "reflects as much firm-specific information as possible"[23]. The importance of a sound pricing system has been stressed by Friedrich Hayek in his seminal work "The Use of Knowledge in the Society". In a society, knowledge never exists in a concentrated form; it is rather spread among various members of the society. "The economic problem of society is thus not merely a problem of how to allocate "given" resources – if "given" is taken o mean given to a single mind which deliberately solves the problem set by this "data". It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know"[24]. Therefore, the main economic task of the society is to ensure a proper utilization of knowledge, which is not available to anyone in its totality. Prices are a useful mechanism for the coordination of individuals' actions. They are, ultimately, a mechanism for conveying useful information within the society. Pricing system is perhaps one of the best mechanisms operating with this purpose, as it requires only summary knowledge on the part of the individuals in order to take the right action. "In

[22] Manne, *supra* note 12, at 4.
[23] Beny, *supra* note, at 246.
[24] Friedrich Hayek, *The Use of Knowledge in the Society* (last visited March 10, 2008) <http://www.econlib.org/Library/Essays/hykKnw1.html >;

abbreviated form, by a kind of symbol, only the most essential information is passed on and passed on only to those concerned"[25].

Firms are generally interested in enhancing their stock's price accuracy, as accurate share prices can improve the quality and efficiency of capital allocation. Highly informative share prices also perform the function of assisting the shareholders in monitoring the overall performance of the firm, by signaling when there are problems. Insiders, possessing superior information, are able to observe discrepancies between shares' price and shares' value. When they detect under-valuation, they buy and as a result, the price rises and tends to adjust to the shares' true value. When the detect over-valuation, they sell, the shares' price drops and tends to follow shares' value. Therefore, insider trading acts as a mechanism designed to provide maximum correlation of shares' prices with shares' value. Other mechanisms that play a significant role in stock pricing are "the explicit public disclosure of new information, sanctioned transmittal of information to financial analysts, and the so-called "derivative" trading that occurs after some time of market "signaling"[26]. The most important mechanism is public disclosure. Opponents of insider trading regulation argue that disclosure is too costly and is sometimes detrimental to the public. Thus, insider trading seems to be a better alternative: "Through insider trading a firm can convey information it could not feasibly announce publicly because an announcement would destroy the value of the information, would be too expensive, not believable, or – owing to the uncertainty of the information – would subject the firm to massive damage liability if turned out *ex post* to be incorrect"[27]. Prohibiting insider trading would simply lead to a delay in the incorporation of valuable information into the share prices.

On the other hand, insiders are not the only market participants who trade on the basis of information they possess and whose trade might trigger an adjustment of the shares price

[25] *Id.*
[26] Manne, *supra* note 12, at 4.
[27] Beny, *supra* note 2, at 12.

in the correct direction. An interesting model was suggested by Professors Goshen and Parchomovsky[28]. They distinguish four main types of participants on the capital market:

- Insiders;
- Information traders (analysts);
- Liquidity traders;
- Noise traders.

Insiders have access to inside information, as well as sufficient dexterities to analyze and price it correctly.

Information traders do not have access to inside information, but they allocate significant resources to gathering information. Information traders are subdivided into three groups: *professional investors*, *specialists/market makers*, and *stock pickers*[29]. *Professional investors* include institutional investors, money managers and other investors, whose investment decisions are based on complex financial and business analyses. In the Goshen/Parchomovsky model, they are also called *analysts*. *Analysts* are well-prepared and equipped to collect and analyze firm-specific information, as well as general market information. Unlike insiders, "analysts, on account of their broader focus on industries and markets, can exploit economies of scale and scope in evaluating and pricing information"[30].

Specialists or *market makers* are professionals who facilitate trading. Their existence on the market is explained by the fact that a stock exchange does not really function as a continuous auction market. Specialists and market makers "make a living by dealing in

[28]Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, (visited Feb. 10, 2008) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=242912 >;
[29] This tripartite classification of information traders was proposed by Goshen and Parchomovsky in their later work "The Essential Role of Securities Regulation". In the initial 2000 model, information traders were divided in two groups: analysts and stock pickers. I use the later model because it distinguishes more precisely between categories of market participants.
[30] Zahar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation* (visited Feb. 10, 2008) <http http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600709 >;

certain stocks, much like dealers in used cares, rare coin, or art"[31]. They offer to buy and sell securities on a continuous basis, setting their "ask" and "bid" price quotations (the price at which they are willing to sell and buy securities, accordingly). This group of traders possesses information about the demand and supply of a security; this information determines their decision how to set the bid/ask spread. Nevertheless, they do not devote as much time and resources to searching and analyzing firm-specific information as professional investors do; thus, they generally possess information of an inferior nature and value as comparing to the information held by professional investors.

Stock pickers base their investment decisions on a financial analysis of the stock, but they usually lack the requisite technical means, professionalism, and financial resources as compared to analysts in order to make a speedy and truthful evaluation of stock. They often buy analytical services from analysts, thereby confirming that analysts are more efficient in gathering and accurately pricing stock.

Liquidity traders do not collect and analyze information, their investments are based on their rational decisions to allocate resources between savings and consumption.

Noise traders are eager to get easy gains and their investment decisions are based on unverified rumors.

It is obvious that only trading by insiders and information traders benefits stock price accuracy. While insiders possess valuable corporate information, information traders are not privy to such information. They are clearly at a disadvantage relative to insiders. Let's assume that an analyst, after having collected and analyzed significant information, believes that the price of the tock represents its true value. If there is any negative inside information and insiders are allowed to trade, they will sell the stock and its price will decline. The decline will be interpreted by the analyst as an undervaluation of the stock and she will buy it,

[31] WANG & STEINBERG , *supra* note 5, at 49.

being confident that the true value is higher than the current market price. Only after the inside information becomes public will the analyst become aware that the stock she bought was overpriced. Trading while there is positive inside information and, correspondingly, insider trading, follows the same scenario, with the same outcome favoring insiders.

Therefore, when insider trading is allowed, insiders will always be several steps ahead of information traders. The profits of information traders will be significantly lower and they will have no incentives to invest in gathering and analyzing market information. It seems that while both insider trading and analyst trading benefit the stock price accuracy, these two cannot coexist. To be more precise, while insider trading is not adversely affected by analyst trading, the latter can flourish only if insider trading is being regulated or prohibited. Accordingly, the main question would be to decide which type of trading serves the stock price enhancement function better.

As a stock price accuracy enhancing device, insider trading has severe shortcomings, as compared to analysts' activity. Insiders are not very efficient in producing general market information; they would rather buy such information from analysts. Analysts, by virtue of their activities are more likely to perform efficiently this task. "Knowledge gained with respect to one corporation in a particular industry can often be used with respect to another, and knowledge pertaining to the economy as a whole is useful in analyzing all corporations"[32]. Insiders produce superior firm-specific information, as compared to analysts, but they lack objectivity in pricing it. Their abnormal returns are explained not by their superior pricing skills, but by the fact that use information before anyone else is aware of it, and they face no competition from outsiders. Insiders' profits are "quasi- monopolistic rents, stemming from insiders' exclusivity over nonpublic information"[33]. Insider trading is advantageous for insiders only insofar as they have exclusive access to information.

[32] Goshen & Parchomovsky, *supra* note 26, at 15.
[33] *Id*. at 20.

Therefore, they lack any incentive to publicize this information, until they consider that the time is reap. This definitely does not work towards improving stock price accuracy. Moreover, insiders might hide their trading through the means of multifarious devices. If the general public believes that this is ordinary trading, not involving valuable undisclosed information, they will not pay too much attention to it and the market prices of the shares will not be affected too much. This allows insiders to take advantage for a longer period of time of the information they possess.

In sum, analysts are a better device in accurately pricing securities than insiders.

1.3.2. Insider Trading and Stock Market Liquidity

It has been generally argued that insider trading hampers stock market liquidity[34]. Insiders possess superior information regarding the "true value" of the stock, as compared to other traders. When the "true value" is higher than the market value, insiders will buy stock. Conversely, when market value exceeds the value deemed to be true according to inside information, insiders will sell their stock. The difference between the insiders buy/purchase price and the "true value" of the stock is of a dual nature. On one hand, it represents a profit for the insider, the very purpose of her trade. On the other hand, it is a trading cost which has to be incurred by the insiders' trade partners. For example, market makers react to insider trading by increasing the bid/ask spread, thus offsetting their risk of trading against insiders. The costs of a wide bid/ask spread will be borne by all traders, regardless whether they are insiders or not. "The market-maker continues to lose to insiders, but if he is lucky, the wider spread will increase gains from outsiders sufficiently to cover the losses to insiders and, equally important, to compensate market-makers for the additional risk that they have to

[34] See, for example, Reineer Kraakman, *The Legal Theory of Insider Trading Regulation in the United States*, *in* EUROPEAN INSIDER DEALING 26 (Klaus J. Hopt and Eddy Wymeersch, 1991).

assume because insiders force upon them large positions”[35]. The higher and the more frequent such transaction costs, the less incentives for the general public to trade on the stock market, this leading to a less liquid market. As a counterargument, it has been argued that most uninformed traders are not influenced in their trading decisions by the existence of parties who are in possession of more information than they are. Even more, knowing that some informed trading takes place on the market, investors might believe that this is the very moment when the prices reflect the true stock value. This is an incentive for them to follow the trend and to buy or sell, depending on what they think that informed investors do.

Insider trading also adversely affects liquidity through its detrimental effects upon competition in the market for information. The possession of valuable information gives insiders an advantage over every other type of traders. Analysts invest a lot of money, skills and time in order to gather and analyze stock market information and to make investment decisions on the basis of this information. Analysts do have an informational advantage related to many other market participants. Nevertheless, they will always lag far behind the insiders relating the value of the information they possess. If insiders are allowed to trade freely on the stock market, then informed traders might find it impossible to compete against them and might be less active on the market. Here again, as in the case of stock price accuracy, the key issue is to choose between two liquidity providers – analysts and insiders, and to protect the best provider. Analysts are considered to provide greater liquidity than insiders, for a number of reasons discussed below[36]. First, insiders are expected to trade less frequently than analysts. Insiders have a single subjective valuation of the corporation and they will trade only when the price differs from their valuation. On the other hand, the more analysts are on the market, the more subjective valuations of the same corporation will

[35] Hartmut Schmidt, *Insider Regulation and Economic Theory*, *in* EUROPEAN INSIDER DEALING 39 (Klaus J. Hopt and Eddy Wymeersch, 1991).

[36] Goshen & Parchomovsky, *supra* note 26.

coexist. Accordingly, there is always a chance that some analyst's valuation of the corporation does not correspond to the market price and this analyst will start trading. Second, "insiders are reluctant to hold stock inventories that will enable them to provide liquidity because they are risk averse and hold undiversified portfolio. Their human capital is invested in the corporation and they will be reluctant to invest their savings in the same corporation"[37]. Analysts' portfolios are diversified, it is the very aim of their business – holding diversified portfolios and adjusting them frequently, thus being able to provide liquidity to the market. Third, insiders possess limited financial resources as compared with analysts. Insiders can't sell inside information to outsiders because of the imminent conflict of interests' problem. Even if they could sell, buying such information would be a risky business, as insiders can manipulate corporate decisions and thereby destroy the value of the information sold. Once again, due to the very nature of their activity, analysts are better prepared to react swiftly to financial demands.

To summarize, analysts are better liquidity providers than insiders. Accordingly, "informed trading in a stock market in which insider trading is illegal yields lower transaction costs than insider trading in a stock market in which insider trading is legal"[38]. This conclusion was supported by an empirical study, which showed that countries with more stringent laws have more liquid stock markets[39].

1.4 Private Regulation of Insider Trading – The "Coasean Theorem"

The debate on the efficiency of insider trading and the various theories presented above are related directly to another major issue: whether insider trading should be regulated by the government or by the private parties. It is clear that if insider trading is viewed mostly through the prism of its agency dimensions, then the case for government intervention might

[37] *Id*. at 22.
[38] Beny, *supra* note 2, at 262.
[39] *Id*.

be weaker; it seems that a problem which lies within the firm should be solved within the firm. On the other hand, taking into consideration alleged detrimental effects of insider trading on the market as a whole; it seems that no private regulation should be allowed.

Private regulation is based on the so-called “Coase Theorem”, presented by Ronald H. Coase in his 1960 article “The Problem of Social Cost”. A summary version of this theorem reads as follows “Regardless of the initial allocation of property rights and choice of remedial protection, the market will determine ultimate allocations of legal entitlements, based on their relative value to different parties”[40]. This theorem stems from the fundamental principle of economics that voluntary exchange offers mutuality of advantage. Legal rules create the initial allocation of rights, which is not always the most efficient one. If there are no impediments to the transferability of rights, the dynamic of the market tends to repair the mistakes of the legislator. Those to whom the rights are assigned will transfer them to other individuals who manifest a stronger interest in holding such rights. Such transfers will continue, “until there is no potential for reciprocal profit, which will not be exhausted until each right is in the hands of the highest-valuing individual”[41]. Thus, the core issue is the rearrangement of legal rights, which “will be done through the market whenever this will lead to an increase in the value of production”[42]. Applying the Coasean theorem to insider trading, it seems that the whole issue revolves around the efficient allocation of the property right in information. Such an allocation will be privately negotiated within the firm and the outcome will be one, which is of utmost benefit for all the participants to negotiations. According to its peculiarities and necessities, each firm will determine whether to allow or prohibit insider trading. Therefore, governmental regulation is not required. However, there are two major conditions for the Coasean model’s viability:

[40] Francesco Parisi, *Coase Theorem* (visited March 16, 2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=981282>;
[41] *Id*. at 2.
[42] Ronald H. Coase, *The Problem of Social Cost* (visited March 16, 2008) <http://www.sfu.ca/~allen/CoaseJLE1960.pdf> ;

- All affected parties are privy to the negotiations; and
- There is no transaction cost related to the chain of exchanges.

As to the first condition, it is difficult to be fulfilled by private negotiations within the firm. Insider trading has spillover effects on the stock market. As mentioned previously, it affects market's liquidity and, in a way or another, it affects most of the market participants. If negotiations are carried within the firm, all affected parties will not be able to take part in them. Even more, prospective shareholders who will be directly affected by the outcome of the negotiations cannot be identified in advance and invited to negotiate.

The second assumption related to the lack of transaction costs does not hold true in the real world. "In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost… Once the costs of carrying out market transactions are taken into account it is clear that such a rearrangement of rights will only be undertaken when the increase in the value of production consequent upon the rearrangement is greater than the costs which would be involved in bringing it about"[43]. When the transaction costs are greater than the difference between the demand and supply prices, the bargaining will not take place and the final allocation of rights will be affected by both initial allocation and the choice of remedies. Proponents of private contracting in regulating insider trading argue that the Coasean approach is feasible and desired solution, as the costs of negotiating insider trading contracts between firms and insiders are minimal: "The costs of negotiating contracts banning insider

[43] *Id*.

trading in the employer-employee situation appear to be low"[44]. Indeed, the costs of drafting and concluding the contract could be reduced to minimum, by inserting in the firm's article of association a provision regulating insider trading. Nevertheless, these are not the only costs incurred in the process of a private regulation under the Coase theorem: "...the notion of transaction costs should include not only bargaining costs associated with the negotiation and conclusion of the contract but also all costs associated with the strategic behavior of the parties and the execution and enforcement of the transaction. The notion of transaction costs should include ex ante costs due to asymmetric information, adverse selection, free riding, and hold-up strategies, as well as ex post costs associated with monitoring and enforcing the contracts"[45]. Most of these costs are encountered in the process of private negotiations on insider trading. These are, e.g., costs related to ex ante investigations performed in order to assess whether insider trading is detrimental for the particular firm. Moreover, the enforcement of contracts prohibiting insider trading proves to be expensive (for example, collective actions initiated by dispersed shareholders are costly), if not impossible at all.

Another problem with the Coasean approach is the free – riding opportunities it offers. According to Easterbrook, firms prohibiting insider trading will not reap all the advantages of doing so because of free-riding by firms that decide not to prohibit insider trading[46]. Once again, it all turns to the issue of costs: "The free rider scenario is what one would expect,

[44] Beny, *supra* note 2, at 19.
[45] Parisi, supra note 38.
[46]Hartmut Schmidt, *Insider Regulation and Economic Theory, in* EUROPEAN INSIDER DEALING 29 (Klaus J. Hopt and Eddy Wymeersch, 1991). In Easterbrook's model, if firm A prohibits insider trading and ensures enforcement of this prohibition, and the market becomes aware of this ban, A's share price rises. Firm B might be willing to reap the same benefits as A, without incurring the costs of enforcing insider trading prohibition. Thus it will mimic firm A, hoping that the market will react by a raise in its share price as well. If the market notices the difference between these two types of firms, A will go on getting its profits, while B will gain nothing from a mere announcement that it has banned insider trading (without really enforcing it). However, if B manages to "fool" the market, investors will be willing to pay more for its shares hoping that they will benefit from an efficient ban on insider trading. Soon investors will become aware that there is some insider trading going on the market but without knowing who is to blame – A or B, they will penalize both firms by paying less for the shares of both types.

because any attempt by a single company to eliminate insider trading is difficult and costly"[47].

Ultimately, if we turn to the positive effects on the market of a ban on insider trading, it does not seem to wise to leave this prohibition at the sole discretion of private parties. If insider trader prohibition generates greater liquidity and higher stock price accuracy, as argued above, the whole issue might resume to the production of a public good. Partly fearing free-riders, partly being guided by some secret purposes of their own, companies might have incentives to under-produce this public good and the market as whole might be hampered.

[47] *Id*.

2. A COMPARATIVE OVERVIEW OF INSIDER TRADING REGULATION

2.1. Development and Basic Features of the Insider Trading Regulation in US

2.1.1. Statutory background

The regulation of insider trading originally was regarded in the United States as an issue related to fiduciary duties of corporate officers and thus pertaining to the realm of state law. Even the adoption on the federal level of the Securities Act of 1933 and the Securities Exchange Act of 1934 did not grant insider trading its current status of a "central feature of modern U.S. securities regulation"[48]. It was only in the 1960's that a complex federal prohibition of insider trading started developing. The evolution of insider trading regulation in the US was shaped by the judicial practice; it was a process "more closely akin to common law adjudication rather than statutory interpretation"[49].

Modern US federal insider trading prohibition is rooted in § 10 (b) of the Securities Exchange Act of 1934, which provides that:

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

b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"[50].

[48] Stephen M. Bainbridge, *An Overview of US Insider Trading Law: Lessons for the EU? 3* (visited Feb. 12, 2008) <http http://papers.ssrn.com/sol3/papers.cfm?abstract_id=654703>;
[49] *Id*.
[50] 15 U.S.C. § 78 j (b)

As one may easily notice, this provision is not self-executing. In order to ensure the functionality of this text, the Securities and Exchanges Commission (SEC) has to enact certain rules and regulations, infringement of which would amount to an infringement of this provision. It is also interesting to note that § 10 (b) does not explicitly address insider trading. The Securities Exchange Act deals with insider trading through a different provision - § 16 (b) – which has quite a narrow scope[51]. Therefore it seems questionable whether by enacting § 10 (b) Congress's intention was to enable SEC to design an insider trading prohibition which went beyond § 16 (b). Nevertheless, in 1942 SEC adopted Rule 10b-5, "the foundation on which modern inside trading prohibition rests"[52]. The Rule provides:

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

a) To employ any device, scheme or artifice to defraud,
b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security"[53].

Just like § 10 (b), Rule 10b-5 does not explicitly mention insider trading. Initially, it covered only cases related to face – to –face and control transactions. It was only in 1961 that

[51] Section 16 (b) allows the issuer to recover insider short-swing profits. The restrictions imposed on insider trading are limited. It applies only to transactions in securities registered under § 12, occurring during a time period of 6 months, performed by persons named in the statute.
[52] Bainbridge, *supra* note 46, at 4.
[53] 17 CFR §240.10b-5.

the SEC extinguished the applicability of Rule 10b-5 to insider trading on impersonal stock exchanges[54].

Due to its uneven development, US insider trading prohibition was characterized as "a creature of SEC administrative actions and judicial opinions, only loosely tied to statutory language and its legislative history"[55]. The courts had to re-examine from time to time the doctrinal basis of insider trading prohibition. Their efforts led to the crystallization of three major theories, which will be briefly analyzed in the following subsection.

2.1.2. The Development of Insider Trading Doctrine

Equal Access Theory

According to the equal access theory, "all traders owe a duty to the market either to disclose or to refrain from trading on non-public corporate information"[56]. This theory stems from *In re Cady, Roberts & Co.* – the first case where SEC held that insider trading on the open market amounted to a Rule 10b-5 infringement. The application of Rule 10b-5 is grounded on two basic elements:

"First, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing"[57].

The first element – "a relationship giving access…to information" was interpreted as representing virtually any means of gathering information about the issuer. The second element – "inherent unfairness" – was seen as unfairness to all other market participants, triggering the duty to disclose. The equal access theory was later supported by the judiciary. In *SEC v. Texas Gulf Sulphur Co.* the Court contended that the aim of the federal insider

[54] In re Cady, Roberts &Co., 40 SEC 907 (1961).
[55] Bainbridge, *supra* note 46, at 5.
[56] Kraakman, *supra* note 32, at 40.
[57] In re Cady, Roberts &Co., 40 SEC 907 (1961).

trading prohibition was to assure that "all investors trading on impersonal exchanges have relatively equal access to material information"[58]. In the Court's opinion, equal access to material information was necessary to ensure that all investors were subject to identical market risks. Under this theory, "virtually anyone who possessed material nonpublic information was required either to disclose it before trading or abstain from trading in the affected company's security"[59].

As one can easily notice, the equal access theory supports a very broad rule, which captures almost any market participant who has obtained material nonpublic information, no matter the means and devices employed in order to gather such information[60]. The very essence of the wrongdoing, according to this theory, lies in taking advantage of the informational disparity on the market, no further qualifications being required. This simplicity was appealing, as it allowed for a rapid identification of the wrongdoers, as well as of the victims of the insider trading. Nevertheless, simplicity was also the major weakness of this theory. "In its unqualified form the equal access theory implies a wholesale allocation of trading rights in non-public information to investors at large…Even if such a general allocation of trading rights was consistent with Rule 10b-5 and the securities acts more generally, it was distinctly at odds with the Supreme Court's own effort during the 1970s to limit liability under Rule 10b-5"[61]. In its first insider trading case, Chiarella v. United States, the Supreme Court rejected the equal access theory and introduced the fiduciary duty theory as a narrower basis for regulating insider trading.

The Fiduciary Duty Theory

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[58] Sec v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), cert denied, 394 U.S. 976 (1969).
[59] Bainbridge, *supra* note 46, at 5.
[60] The so-called "informed traders", discussed in section 1, allocating significant financial and other resources in order to gather and analyze market information, were not subject to the "disclose or abstain rule". Had they been subject to this requirement, their activity would have become useless and they would have had to exit the market.
[61] Kraakman, *supra* note 32, at 41.

The fiduciary duty theory, also known as the classical special relationship theory is a creation of the Supreme Court of the United States, through two seminal cases – Chiarella v. United States[62] and Dirks v. SEC[63]. In Chiarella, the Supreme Court overturned the criminal conviction of a financial printer for having traded on knowledge of prospective takeover bids. The Supreme Court reversed the conviction on the ground that "a trade based on material nonpublic information does not per se trigger a duty of prior disclosure"[64].There should be an affirmative duty to disclose, based on a "relationship of trust and confidence between parties to a transaction"[65]. It is important to note that the source of this fiduciary duty is a pre-existing fiduciary relationship outside Rule 10b-5. Judge Easterbrook stated it clearly:

"When the nature of the offence is a failure to "blow the whistle", the defendant must have a duty to blow the whistle. And this does not come from §10 (b) or Rule 10b-5; if it did, the inquiry would be circular. The duty must come from a fiduciary relation outside securities law"[66].

The effect of Chiarella was a substantial narrowing of the scope of insider trading prohibition.

In Dirks, the Supreme Court extended the fiduciary duty theory in order to reach trading by the tippees of insiders. In this case, a securities analyst was informed by a company's insiders of the existence of a fraudulent scheme within the company. This information was conveyed by the analyst to certain institutional investors who traded on its basis and managed to avoid losses after the collapse of the scheme. The Supreme Court reversed the sanction imposed by SEC. The Court held that tippee trading represented a derivative violation of Rule 10b-5. The tippee originally has no fiduciary relationship with the issuer's shareholders. If the tipper breaches her fiduciary duties and the tippee knows or

62 Chiarella v. United States, 445 U.S. 222, 227 – 229 (1980).
63 Dirks v. SEC, 463 U.S. 646, 653 (1983).
64 WANG & STEINBERG , *supra* note 5.
65 Chiarella v. United States, 445 U.S. 222, 227 – 229 (1980), at 230.
66 Barker v. Henderson, Franklin, Starnes & Hold, 797 F.2d 490, 496(7th Cir. 1986).

should know about the breach, then the tippee can be held liable under Rule 10b-5. The tipper breaches her duty not by merely disclosing the information; rather the breach occurs when the tipper benefits from the disclosure[67]. Therefore, personal benefit of the tipper is a sine qua non condition for the tippee's liability. In Dirks, the tippers were corporate whistle-blowers, who obtained no personal benefit and breached no fiduciary relationship. Hence, there was no tippee violation of Rule 10b-5 either. It is interesting to note that the Dirks opinion "reflected a strong interest in limiting the liability of security analysts, whose research it depicted as an important contributor to the efficiency of securities prices"[68].

The fiduciary duty theory is more market-oriented than the equal access theory. The broad rule of informational parity, promoted by the equal access theory, was harmful for the market, it threatened "to chill the production and release of socially valuable trading information, and so injure public investors and the market in the long run"[69]. However, the fiduciary duty theory had its own drawbacks. The most important criticism of this theory is that it can't serve as a functional basis for assigning trading rights in non-public information[70]. This issue goes beyond the fiduciary relationship. If one accepts the market theory of insider trading, one should agree that the fiduciary relationship theory is unable to cover all insider trading cases with negative implications for the market. A further refinement was offered by the misappropriation theory.

The Misappropriation Theory

The SEC tried to mitigate the consequences of Chiarella decision, by promulgating Rule 14e-3[71]. This Rule regulated insider and tippee trading in the tender offer context[72]. The

[67] The definition of "benefit" shouldn't be confined to the "quid pro quo" setting. The Court in Dirks held that the benefit can be indirect and might include an enhancement of reputation that will translate into future earnings, an expectation of reciprocal tips, or even a good feeling when giving confidential information to a friend or relative.
[68] Kraakman, *supra* note 32, at 43.
[69] *Id.*
[70] *Id.*
[71] 17 C.F.R. §240.14e-3; Securities Exchange Act Release No. 17120 (1980 Transfer Binder) Fed.Sec.L.Rep. (CCH).

equal access theory offered too broad grounds for liability. The fiduciary duty theory, on the other hand, seemed to be under-inclusive, without reaching cases it was felt that should have been reach, in order to ensure the protection of the market. The misappropriation theory was designed to protect the market, without limiting the applicability of Rule 10b-5 liability only to corporate insiders, but reaching market insiders as well. In its simple form, the misappropriation theory holds that any trading on the basis of non-public information acquired by theft or breach of a duty of confidentiality violates Rule 10b-5. Therefore, under this theory, Rule 10b-5 is applicable to trading that violates a duty of confidentiality to any source of market information. Although a similar line of reasoning was invoked in the Chiarella case, it wasn't until 1997 that the Supreme Court endorsed the misappropriation theory, in the US v. O'Hagan case[73]. The Court grounded liability under the misappropriation theory on the breach of a fiduciary duty owed to the source of the information. The Court held that "a fiduciary's undisclosed, self serving use of a principal's information to purchase or sell securities in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information"[74] and thus violates Rule 10b-5.

The misappropriation theory poses many new questions. One major issue is whether there would be any liability under this theory for the so-called "brazen misappropriators". Disclosure to the source of information seems to be the only requirement in order to avoid liability under Rule 10b-5, but the theory fails to address the situation where after disclosure the source of information objects to the trading. It seems like such a trading will be held legal, despite those objections.

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[72] Rule 14e-3 prohibits persons who are in possession of material non-public information relating to a tender offer from trading in the target company securities, if the possessors of this information know or have reasons to know that this information is non-public and was received directly or indirectly from bidder or target insiders. This prohibition applies if the bidder has commenced or has taken substantial steps towards the commencement of the bid. Rule 14e-3 also prohibits insiders of the bidder and target companies from communicating material, non-public information related to a tender offer to any other person, if such communication might result in these persons' trading on the basis of this information.

[73] 521 U.S. 642 (1997).

[74] *Id.*

Another criticism to this theory is based on the claim that "a simple property rights approach to information may oversimplify the problem of market insiders. By assigning ownership of non-public market information to an employer or principal, the misappropriation theory ignores a wider matrix of relationships that suggests that public shareholders may also have a claim to trading rights"[75]. In the broad context of market activity, the alleged owners of the misappropriated information are not the only victims of the trading on the basis of information deemed to be theirs. Nevertheless, this theory confines the limits of traders' liability to the claims of the source of information, which doesn't seem to benefit market efficiency.

2.1.3. Elements of the Modern Prohibition

a) The duty to disclose or abstain arises only relating to material inside information. Therefore, an important issue to be determined in order to ascertain liability under Rule 10b-5 is the definition of materiality of information. One of the first Supreme Court's decision addressing the materiality of a fact in a corporate context was *Mills v. Electric Auto-Lite*[76]. Here the Court considered a fact material if a reasonable shareholder *might* consider it important in deciding how to vote[77]. Such a definition, based on mere possibility that a shareholder would attach importance to the facts under revision, encompassed a broad range of facts which had to be disclosed in order to avoid liability under this standard. The general concern was that "a minimal standard could bring an overabundance of information within the reach of "materiality" and lead management to simply bury the shareholders in an avalanche of trivial information which in turn would interfere with informed decision-making"[78]. Hence, in an attempt to narrow the standard of materiality, in *TSC Industries, Inc. v. Northway* the Supreme Court defined a fact as being material "if there is a *substantial*

[75] Kraakman, *supra* note 32, at 46.
[76] 396 U.S. 375 (1964).
[77] *Id.*
[78] WANG & STEINBERG , *supra* note 5, at 130.

likelihood that a reasonable shareholder would consider it important in deciding how to vote"[79]. The abovementioned cases referred to shareholder voting. The same standard of materiality – substantial likelihood that a reasonable shareholder would act upon such facts - has been adopted by the Supreme Court for the applicability of Rule 10b-5 in *Basic Inc. v. Levinson*[80].

There are multifarious factors looked upon in order to determine the materiality of the information. They include, inter alia, trading and profit making upon this information by the insiders[81], market reaction when the information is disclosed[82], as well as the source of the information – in case of tippee trading[83]. Soft information, or information that cannot be supported by facts and involving subjective appraisals could amount to material information, taking into consideration all the circumstances of the case[84]. An interesting approach towards the issue of materiality is the so – called "mosaic approach". According to this concept, information which is not material *per se,* becomes material when the defendant combines it with other items of information known to her and creates a "mosaic" that might determine her market behavior. [85] However, such an approach is most likely to harm market analysts in the first place, since they have all the necessary skills to combine bits of information and to view a picture that might remain unseen by the ordinary investors. The SEC was aware of analysts' importance for the preservation of a healthy market and rejected the "mosaic" approach[86]. The viability of this theory is still questionable.

[79] 426 U.S. 438 (1976).
[80] 485 U.S. 224 (1988).
[81] See, for example, Basic Inc. v. Levinson, 485 U.S. 224 (1988); SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968); Rotheberg v. Rosenbloom, 771 F.2d. 818 (3d Cir. 1985).
[82] See, for example, SEC v. Tome, 638 F.Supp. 596, 623 (S.D.N.Y. 1986); United States v. Carpenter, 791 F.2d 1024 (ed Cir. 1986).
[83] See, for example, Burlington Indus., Inc. v. Edelman, 666 F.Supp. 799, 817 (M.D.N.C. 1987).
[84] In Elkind v. Liggett & Meyers, Inc. (635 F.2d 156, 2d Cir. 1980) the information that there was a good possibility that the quarterly earnings would be low was held material.
[85] This approach was fostered by the Supreme Court in Basic Inc. v. Levinson (485 U.S. 224, 1988), which held that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available".
[86] In re Dirks, 47 SEC 434 (1981), Exch. Act. Rel. No. 17480.

b) Another important element of the insider trading liability is the non-publicity of the information which served as a basis for trading. The moment when the information becomes public delineates the point from where trading on the basis of such information is allowed. This justifies the importance of an accurate determination of this demarcation line. There are two general theories on determining when material information becomes public:

- the dissemination and absorption theory, and
- knowledge by active investment community theory[87].

According to the dissemination and absorption theory, information becomes public after it has been "effectively disclosed in a manner sufficient to insure its availability to the investing public"[88]. Mere dissemination does not suffice for the information to become public; it has to be absorbed by the investing community. The period during which the information is deemed to have been absorbed is determined on a case-by-case basis.

According to knowledge by active investment community theory, the information is deemed public if a large part of the investment community is aware of this information[89]. No other requirement relating to dissemination or absorption has to be fulfilled. The disadvantage of this criterion is its flexibility and subjectivity. There are too many subjective elements tied to this theory. For example, the large part of the investment community is supposed to be aware of the information if price and volume of the stock traded reflects in a proper way the essence of the information. Nevertheless, the degree to which information has to be incorporated in the volume and price of the stock depends on courts' assessment. For example, in one case the court held that "the information was not fully impounded in the price at the time of the defendants' trade"[90]. The requirement for a "full" inclusion of the information in the stock price does not take account of the market reality, especially in highly

[87] For a review of both theories, see WANG & STEINBERG , *supra* note 5.
[88] SEC v. Texas Gulf Sulphur, 401 F2d. 833, 853 (2d Circ. 1968).
[89] See, for example, SEC v. Bausch & Lomb, 595 F.2d 8 (2d Cir. 1977).
[90] United States v. Libera, 989 F.2d 596, 601 (2d Cir).

volatile markets. It often happens that at the moment T the stock is undervalued on the market, while at the very next moment T+1 the stock is overvalued, on the basis of some information becoming known on the market. Finding the perfect moment in-between T and T+1, in order to trade, is a very difficult task. Moreover, even among professional analysts there are discrepancies as to whether at a given moment the stock's price fully reflects is value. Why would a court be more successful in determining this moment remains a question to be answered.

c) Another important component of insider trading prohibition is scienter. Scienter is a sine qua non element of a violation of § 10 (b) and Rule 10 b-5. Scienter could be defined as "a mental state embracing intent to deceive, manipulate, or defraud"[91]. One of the key problems related to the scienter requirement is whether mere possession by the insider trader of the undisclosed material information suffices in order to trigger liability under Rule 10b-5, or should the trade be induced by that information. The SEC advocates in favor of the "possession" standard[92]. The judiciary did not come with a unified solution to this issue[93]. The dispute was solved with the adoption by SEC of Rule 10b5-1, which endorses the "on the basis of" standard – one which is similar to the "possession" standard. Nevertheless, this Rule provides for a wide range of affirmative defenses for those trading pursuant to a pre-existing plan, instructions, or contract.

d) Finally, one of the key issues in examining the concept of insider trading is defining the "insider". The term "insider trading" is clearly a misnomer, as "the modern federal insider trading prohibition proscribes a corporation's officers and directors from

[91] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
[92] See, for example, the Report of the Investigation in the matter of Sterling Drug Inc., Securities Exchange Act Release No. 14,675, 14 SEC Docket 824, 827 (1978), where SEC pointed that Rule 10b-5 "does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information…If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public".
[93] In United States v. Teicher (987 F. 2d , 2d Circ., 1993) the Second Circuit approved the possession standard, while in SEC v. Adler (137 F. 3d 1325, 11 Circ., 1998) the Eleventh Circuit opted for the "use" standard.

trading on the basis of material nonpublic information about their firm, but it also casts a far broader net"[94]. Therefore, it was the task of the judiciary to establish who the subjects of insider trading prohibition were. The prohibition extends to corporate employees, actual and former[95]; independent contractors[96]; "temporary insiders", who are neither employees nor independent contractors of the issuer, but assume the duties of an insider temporarily, on the basis of a special relationship with the corporation[97], controlling shareholders.

2.2. Development and Basic Features of the EU Insider Trading Regulation

2.2.1. Introductory Note

Prior to the enactment of insider trading regulation at a pan-European level, each European country had its own approach to this phenomenon, varying from criminalization of insider trading to a blatant ignorance of this issue.

France was one of the first European countries to regulate insider trading by an Ordinance dated September 28, 1967[98]. Even more, in 1970 insider trading and tipping were qualified as criminal offences under French law. Other European countries were not as eager to ban insider trading through legislative means and preferred leaving it to voluntary regulation by market participants. "Resistance to legal regulation of insider dealing and even more so to making this a penal offence was particularly stiff in Germany"[99]. Germany, Spain, and the Netherlands initially regulated insider trading through voluntary codes of conduct. Germany issued the "Guidelines on Insider Dealing" in 1970. The Guidelines were drafted by

[94] Bainbridge, *supra* note 46, at 9.
[95] See, for example, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (CA 2 1968), for a case involving mid-level employees; SEC v. Brethen, Fed. Sec.L.Rep (S.D. Ohio, 1992), for a case involving a former director and CEO.
[96] In Dirks v. United States, 646 (1983), in the notprious "footnote No. 14", the Supreme Court held that the prohibition extends to such independent contractors, as "an underwriter, accountant, lawyer, or consultant working for the corporation".
[97] SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983). Nevertheless, it has to be mentioned that there isn't any univocal opinion regarding temporary insiders.
[98] The 1967 Ordinance added a new provision to the 1966 Companies Act. According to this new provision, corporate directors and officers were required to report their securities dealings to the Commission des Operations de Bourse.
[99] Klaus J. Hopt, *The European Insider Dealing Directive in* EUROPEAN INSIDER DEALING 132 (Klaus J. Hopt and Eddy Wymeersch, 1991).

the German Commission of Stock Exchange Experts and were signed up by the representatives of listed companies. It was only in 1994 that Germany enacted a law prohibiting insider trading. Spain too initially tackled insider trading through a Code of Conduct, drafted in 1977. The first Spanish legislative prohibition of insider trading is to be found in the Securities Law passed in 1988. In the Netherlands, the 1987 Model Code applied to companies listed on the Amsterdam Stock Exchange prohibited insider trading, while the 1989 amendments to the Criminal Code made insider trading a criminal offence. United Kingdom enacted a law prohibiting insider trading and qualifying it as a criminal offence in 1980.

The first attempts to regulate insider trading on a European level date back to the Statute of the Societas Europaea (SE) as proposed in 1970. The draft article 82 provided for mandatory insider registration and recovery by the Societas Europaea of insiders' profits arising from short-swing transactions in SE securities within a six months period[100].

In 1977 the Commission of the European Communities issued a formal recommendation to the member states regarding a European Code of Conduct Relating to Transactions in Transferable Securities[101]. This Recommendation was "a blueprint for further legally binding action"[102]. Despite Germany's strong opposition to the adoption of any legally binding harmonization instrument, the Insider Dealing Directive 89/592 EEC[103] (*further on – the Insider Dealing Directive*) was adopted in 1989, followed by the adoption of the Market Abuse Directive 2003/6/EC[104] (*further on – the Market Abuse Directive*) in 2003.

[100] This provision was clearly inspired by Section 16 of the US Securities Exchange Act of 1934. Nevertheless, as the scope of that insider trading regulation was too narrow, being restricted only to the SE and thus not corresponding to the market requirements in establishing a general insider trading prohibition, the 2003 Statute of the SE does not contain such a provision any more.

[101] Commission Recommendation of 25 July 1977, OJ 20 August 1977, L 212/37.

[102] Hopt, *supra* note 97, at 132.

[103] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ 18 November 1989, L 334.

[104] Directive 2003/6/ EC of the European Parliament and of the Council of 28 January 2003, on insider dealing and market manipulation (market abuse), OJ 2003 L96, p.16.

2.2.2. Insider Trading under the Directive 89/592/EEC

The Insider Dealing Directive was adopted at a time when "market regulation was still in its infancy in many member states"[105]. It was actually the first directive designed to regulate capital markets. These factors, as well as the "minimum harmonization" standard of the Directive led to rather different outcomes in the implementation of the Directive in the Community Member States.

I shall focus on examining the basic elements of the Insider Dealing Directive and the first one to be analyzed is the concept of inside information. Inside information has been described as a key concept of each insider trading regulation, as "the concept of insider and insider papers and even more the various obligations or prohibitions set out in an insider regulation are all drawn from the concept of inside information"[106]. According to Article 1 (1) of the Directive, inside information is "information which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have a significant effect on the price of transferable security or securities in question". This definition has the following four characteristics:

I. The information has not been made public. For the purpose of the Directive the confidentiality of the information is irrelevant. All that matters is only the fact that the information has not been made public. A crucial issue to be addressed in this context is the determination of the moment when a piece of information is deemed to be made public. The member states' views on making the information "public" were multifarious. Some, like UK, took the view that publication to market professionals is sufficient to make the information

[105] "Comparative Implementation of EU Directives (I) – Insider Dealing and Market Abuse", The British Institute of International and Comparative Law, December 2005.
[106] Hopt, *supra* note 97, at 133.

"public"; others, like France, required an almost universal knowledge of the information[107].In France, for example, the judicial practice qualified as non-public information, which was published in a periodical with a limited circulation[108]. Similarly, French judicature held as non-public information, which was spread to third parties, provided that these third parties represented only a small part of the total number of stock exchange dealers[109]. Thus, the French interpretation of information that could be regarded as public was rather strict and narrow[110].

UK was situated on the opposite side of the spectrum. The 1993 Criminal Justice Act, implementing the Insider Dealing Directive, distinguished between cases where information *had to* be considered public and cases where information *could* be deemed public. The Act expanded the meaning of information which was made public and provided looser criteria for establishing it. As opposed to France, where information had to be available to the "man on the street", in order to be considered public, in the UK information communicated to a part of the market, such as professional investors, for example, could have been treated as having been made public, regardless of the ordinary investor's knowledge of it[111]. In general, information was made public if it was published in accordance with the rules of a regulated market; if it was contained in the records which were open to public inspection; if it could be readily acquired by those likely to deal in securities to which the information was somehow pertinent, as well as if that information was derived from public information.

[107] *Supra* note 103.
[108] Cour d'Appel, Paris, Ministere Public c. D JCP 1978.II.18789.
[109] Tribunal de Grande Instance, Paris, Ministere Public c. Gustave P, JCP 1980 II 19306.
[110] It has to be mentioned that the cases referred to above were solved prior to the implementation of the Insider Dealing Directive in France. These cases were decided on the basis of the 1967 Ordinance. The Insider Dealing Directive was implemented through the Regulation 90-08 on the Use of Inside Information, promulgated in 1990 by the Commission des Operationes de Bourse (COB). There were thus two packages of regulations related to insider dealing: criminal law under the 1967 Ordinance and administrative rules under the 1990 COB Regulation. However, there is no reason to believe that had those cases been solved later, after the implementation of the Insider Dealing Directive, the Courts would have used different criteria in determining whether the information had been made public.
[111] Other cases when information *could* have been treated as public included information that could be acquired only by persons exercising diligence or expertise; information that could be acquired only by observation; information communicated only on the payment of a fee, as well as information published only outside the UK.

II. The second characteristic is the precise nature of the information. This requirement was aimed at leaving out of the scope of the Insider Dealing Directive those trades, which were effected on the basis of speculations and rumors. Such a restriction was regarded as indispensable for a sound market, as "without rumors and speculations the market is not alive"[112]. Nevertheless, information that was precise could not be confined to mere facts[113]; predictions and forecasts were usually regarded as having been covered by the Insider Dealing Directive. Therefore, interpretations given to the precise nature of inside information were, to a certain degree, uniform in the member states, without raising too many questions.

III. The third characteristic is the information's pertinence to one or several issuers of transferable securities or to one or several transferable securities. Information relating to the issuer could originate from within the company (for example, information relating to dividends), as well as from outside the company (from a potential bidder in the context of a takeover bid concerning the company). Information relating to securities could also originate from outside the company (for example, a stock exchange decision to include a company in its listing). The information covered by the Directive includes information which has direct consequences for the market, without any direct and immediate consequences for the given securities. Examples could be given of news related to a Central Bank's decision to modify the discount rate, political news, legislative information, etc. This is definitely too broad a coverage, but limits for the definition of inside information "must be looked for elsewhere, namely in the concept of insider and the professional prohibitions and duties imposed on them by the directive"[114].

IV. The fourth characteristic is the price sensitivity of insider trading information. According to the Directive, inside information must "be likely to have a significant impact on

[112] Hopt, *supra* note 97, at 134.
[113] It is interesting to note that the Securities Trading Act of 1994 (Wertpapierhandelsgesetz, WpHG) implementing the Insider Dealing Directive in Germany refers to the term "fact" instead of "inside information", without using the term "precise".
[114] Hopt, *supra* note 97, at 134.

the price", if it were made public. The actual effect of the information on the stock quotations is not relevant for this qualification. The likeliness of the information's impact on the stock prices has to be ascertained on a case-by-case basis. The Directive also requires for a significant impact on the price, without providing any guidelines for the member states on what might amount to a significant effect. Member states took different views on this issue in drafting their legislation that implemented the Directive. France, for example, provided that any effect on the price of securities might suffice for qualifying information as inside information[115]. On the other hand, in Germany, "under the WpHG 1994 it was generally accepted that certain thresholds such as 5% for shares of DAX companies could be used as a measure of significant effect"[116].

Several further general comments regarding the meaning of inside information under the Insider Dealing Directive are necessary. One more point to note is the Directive application to the bidder in the context of a takeover bid. Although the information held by the bidder regarding the takeover reflects all the abovementioned characteristics, the bidder is not barred from buying shares ahead of the public announcement of the bid. According to the preamble of the Directive, "since the acquisition or disposal of transferable securities necessarily involves a prior decision to acquire or to dispose taken by the person who undertakes one or other of these operations, the carrying-out of this acquisition or disposal does not constitute in itself the use of inside information"[117]. Some commentators argue that this is just a formal line of reasoning, "the real economic and legal reason is that the future bidder shall be allowed to buy up shares silently up to the percentage as of which there is mandatory disclosure"[118].

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[115] Article 1 of the Regulation No. 90 - 08 on the Use of Inside Information adopted by the Commission des Operationes de Bourse.
[116] *Supra* note 103.
[117] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ 18 November 1989, L 334
[118] Hopt, *supra* note 97, at 135.

The Directive protects the so-called “informed traders” by stating expressly in the preamble “estimates developed from publicly available data cannot be regarded as inside information and … therefore, any transaction carried out on the basis of such estimates does not constitute insider dealing within the meaning of this Directive”[119]. This provision envisages the activity of investment advisers and portfolio analysts, whose success on the market directly depends on their ability to collect and analize all available data.

Another important element of the insider trading prohibition is the determination of the group of persons to whom such prohibition applies. It has to be mentioned that the Directive generally speaks about natural persons (article 2 (2) of the Insider Dealing Directive). Member states took different views on this issue, when implementing the Directive. “Where the IDD was implemented through the criminal law, in general, liability attached only to the individuals involved in the insider trading and not to the company on whose behalf they are dealing”[120]. This was the case of UK. In France, for example, the insider trading prohibition applied to both companies and individuals.

The Directive distinguishes between two major groups of insiders. The first group consists of persons who possess inside information by virtue of their link to the company; the second group is represented by persons who get inside information from the first group. Although the Directive does not explicitly “label” these groups, the first group is usually referred to as primary insiders and the second one – as secondary insiders[121]. The first group of insiders consists of three subcategories, as provided in Article 2 (1) of the Insider Dealing Directive:

- Those who possess information by virtue of their membership of the administrative, management or supervisory bodies of the issuer of the securities in question. In

[119] *Supra* note 115.
[120] *Supra* note 103.
[121] Hopt, *supra* note 97, at 136.

implementing this provision, Germany extended the prohibition to members of the board of a company in any company in a group of companies[122].

- Those who possess information by virtue of their holding in the capital of the issuer. The Directive does not establish any threshold, virtually any minor and insiginficant participation in the issuer's capital would suffice, although in practice "shareholders with shareholdings under 10% will rarely possess indsde information by virtue of being shareholders"[123]. In implementing this provision, France did not include shareholders in the list of insiders[124].
- Those who possess information by virtue of the exercise of their employment, profession or duties. This is a very broad group, it includes insiders who are closely linked to the issuer, for example employees or auditors, as well insiders who are not directly related to the issuer, such as public officials. Due to the definition of inside information, which is broad enough to cover both company – related and market – related information, persons possessing information which influences only the market as such are, nevertheless, deemed to be primary insiders.

In this context, several comments will be made. First of all, it has to be noted that in order to qualify as a primary insider, no fiduciary relationship has to be proved. Some of the primary insiders mentioned above might have such a relationship with the issuer, while the others – members of the Securities Commission or memebers of the Central Bank, who have access to inside information due to their status – have no direct relationship with the issuer. Secondly, as far as family members are concerned, the Directive does not speek of any insider trading prohibition applicable to them. They might fall under the provisions of the

[122] Section 13 of the WpHG 1994.
[123] Hopt, *supra* note 97, at 136.
[124] Article 2 of the COB Regulation No. 90-08. Shareholders might be caught by the insider trading prohibition, though, only if they are involved in the preparation and execution of a financial transaction, under the general rule of the Article 3 of the COB Regulation 90-08.

Directive if they receive inside information from a primary insider, thus becoming themselves secondary insiders, just like anyone else would become, in such circumstances.

The second major category of insiders are the so-called "secondary insiders". Article 4 of the Insider Dealing Directive provides that the insider trading prohibition extend upon "any person…who with full knowledge of the fact possesses inside information, the direct or indirect source of which could not be other than a person referred to in Article 2". To say it differently, secondary insiders possess inside information by virtue of a leak of such information from primary insiders. Primary insiders could convey inside information to secondary insiders by various means. The most important means of conveying inside information, expressly regulated in the Directive, is tipping. Article 3 of the Directive prohibits primary insiders from disclosing the inside information to third parties, as well as recommending and procuring a third party on the basis of inside information to acquire or dispose of transferable securities. Disclosure is possible, only if it relates to the normal course of the exercise of the primary insider's duties, profession, employment. Tippees become secondary insiders due to the will of a primary insider. A primary insider might also convey information to third parties without being aware of this fact. For example, a person might qualify as a secondary insider regardless of the will of a primary insider, as is the case of a person who overheard a conversation of two primary insiders. A primary insider might also deliberately convey information to one single person, without having the intention that such information reaches somebody else. Nevertheless, subsequent tips could pass the information to persons of whose existence the primary insider is not even aware of. It is obvious, thus, that secondary insiders is a concept which "goes beyond the mere direct tippees"[125].

[125] Hopt, *supra* note 97, at 136.

Secondary insiders are prohibited only from trading on the basis of the inside information. According to Article 6 of the Directive, the tipping prohibition is optional, depending on the member states' will while transposing the provisions of the Directive.

Finally, I shall address the insider trading prohibition itself. It is stated in article 2 of the Directive and prohibits insiders from taking advantage of the inside information with full knowledge of the facts by acquiring or disposing of for his own account or fr the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates. An imporatnt element of the insider trading prohibition is that the insider took advantage of the information. Mere use, though with full knowledge, of the inside information, does not suffice. The insider has to take advantage of the information in relation to his concrete copunterparty, and not in relation to the market as a whole. This was emphasised in the Georgakis case, decided by the ECJ in 2007[126]. This case concerned a reference for a preliminary ruling regarding the interpretation of articles 1 to 4 of the Insider Dealing Directive. The reference has been made in the context of proceedings between the Greek Ministery for Economic Affairs and a local Greek tax authority, on the one hand, and Mister Georgakis, on the other, concerning the latter's alleged insider dealing. Mr. Georgakis and several members of his family, referred to as "the Georgakis group", were shareholders and board memebers of the company "Parnassos". Following a decline in the Parnassos shares' price, the Georgakis group was advised by its financial adivisers to support the price of the shares by underatking a series of transactions in those shares. Members of the group bought and sold "Parnassos" shares between themeselves, in order to give a fictious impression of an increasing number of transactions in those shares and to raise their value. The Court emphasized that the Directive's purpose was to ensure the proper functioning of the secondary market in transferable securities and to ensure investors' confidence, by,

[126] Ipourgos Ikonomikon, Proistamenos DOI Amfissas v.Charilaos Georgakis (Case C-391/04), ECJ, 10 May 2007.

particularly, placing them on an equal footing. Accordingly, the Court viewed the prohibition laid down in article 2 of the Directive as aiming at ensuring "equality between the contracting parties in stock-market transactions by preventing one of them who possesses inside information and who is, therefore, in an advantageous position vis-à-vis the other investors, from profiting from that information, to the detriment of the other party who is unaware of it"[127]. In the Georgakis case, parties to the transactions were on an equal footing, as they all possessed the same information, they were all aware of the decision taken between themselves; nobody was in a position to take advantage of that information over the others. Thus, although the parties to the transactions were insiders and there was inside information, nevertheless there was no insider trading involved, as there was no taking advantage of such information.

Another important element of the insider trading prohibition is the full knowledge of the facts, meaning that mere negligence would not suffice.

The insider trading prohibition as such applies to all transactions involving intermediaries, such as brokers. Nevertheless, the member states were allowed to exempt transactions effected without the involvement of a professional intermediary outside an official market.

2.2.3. Insider Trading under the Directive 2003/6/EC

The Insider Dealing Directive was one of the first Community Directives aimed at regulating financial markets. Its pioneering character as well as its "minimum harmonization" requirement led to several loopholes and varying interpretations of the Directive concepts throughout the member states. Although the main purposes of the Insider Dealing Directive were to ensure protection of market integrity and to enhance investor confidence in those markets, it only tackled insider trading, without addressing other major phenomena occuring

[127] *Supra* note 125, at Para 38.

on the market and endangering the attainment of the objectives stated in the preamble of the Insider Dealing Directive. These factors conditioned the adoption of a new Community Directive – Directive 2003/6/EC on insider dealing and market manipulation (market abuse)[128]. This Directive shall be referred to further on as Market Abuse Directive. According to recital (11) of the Market Abuse Directive, the existing Community legal framework to protect market integrity was incomplete; member states adopted varying provisions in this area, "leaving economic actors often uncertain over concepts, definitions and enforcement". Recital (13) emphasizes that "a new Directive is also needed in order to avoid loopholes in community legislation which could be used for wrongful conduct and which undermine public confidence and therefore prejudice the smooth functioning of the markets".

Many of the provisions of the Insider Dealing Directive can be found in the Market Abuse Directive. However, there are still many significant differences between these two and I shall further focus on them. A major difference relates to the legislative techniques employed in the process of adoption of the directives. Thus, the Market Abuse Directive is a result of the "Lamfalussy Process" and it represents the first level of a "multi-leveled and comprehensive set of provisions"[129], providing basic legal framework. At the second level, additional Community instruments provide technical details[130]. At the third level, national securities regulators through the Committee of European Securities Regulators provides guidance on the common operation of the Directive. Finally, on the fourth level, the Commission ensures compliance with EU instruments.

[128] *Supra* note 103.
[129] Mathias M. Siems, The *EU Market Abuse Directive: A Case-Based Analysis* (visited March 25, 2008) <http
[130] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation; Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest; Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices; Commission Regulation (EC) No 2273/2003 on Market Abuse.

Another difference relates to the scope of the two directives. The scope of the Market Abuse Directive is broader than the scope of the Insider Dealing Directive. The former covers insider dealing, as well as ad-hoc publicity and market abuse.

Another major difference between the two directives is that the Market Abuse Directive follows the concept of "maximum harmonization", requiring the member states to adopt rules, which are to a maximum extent similar to its provisions. Due to this requirement, "Member States have moved towards verbatim or "copy-out" implementation and in so doing have aligned their national laws"[131].

Now I shall consider the evolution of the insider trading prohibition under the Market Abuse Directive. As far as the definition of "inside information" is concerned, it remains virtually identical to the definition provided in the Inside Dealing Directive. Inside information retains its four characteristics, namely, the non-public nature, precise nature, price sensitivity, and its attribution to issuers or financial instruments. Nevertheless, there is a small refinement brought by the Market Abuse Directive to the latter characteristic, by specifying that the information might relate to the issuers or financial instruments in a direct or indirect manner. I shall make several comments regarding each of the four characteristics of the inside information under the Market Abuse Directive.

I. The information has not been made public. Being aware of the broad spectrum of interpretations given by the member states to the non-public characteristic of the information under the Insider Dealing Directive, the Committee of European Securities Regulators (further on - CESR) attempted to offer some guidelines in ascertaining the non-public character of a piece of information. Thus, in making information public, "companies with inside information to disclose should use the disclosure mechanisms specified by their Competent Authority. Therefore, for example, if they are required to make information

[131] *Supra* note 103.

publicly available through a particular electronic news service it will not necessarily be sufficient for them only to give the information to a newspaper. However, for the purposes of determining whether a transaction was made using inside information, it should be noted that information can be publicly available, even if it was not disclosed by the issuer in the specified manner. This applies whether the information became public through an incorrect disclosure by the issuer or through a third party"[132]. CESR also specifies that information may also be considered publicly available if it is made accessible on a commercial basis, conditioned upon the payment of a fee. This seems a clear departure from the French strict interpretation of public information under the Insider Dealing Directive as information available to the "man on the street".

II. The precise nature of the information. Directive 2003/124/EC sheds light on the meaning of the term "information of a precise nature". According to this Directive, information is deemed to be of a precise nature "if it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so and if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments".[133] This definition is designed to leave aside market speculations and rumors, just as it happened under the Insider Dealing Directive. In the case of information regarding a process occurring in stages, information about each stage of the process, as well as information about the process as a whole, falls under the definition of "information of a precise nature". Further, the precise nature of the information does not necessarily imply that the information is comprehensible. For example, information regarding a prospective bid for one or other of two companies

[132] "Market Abuse Directive Level 3 – Second set of CESR guidance and information on the common operation of the Directive to the Market", the Committee of European Securities Regulators, July 2007.
[133] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, Article 1.

might amount to information of a precise nature, even though the concrete target is unknown. Finally, information might be considered specific enough to allow a conclusion to be drawn about its eventual impact on prices in at least two instances, according to the CESR. The first one is "when the information is such as to allow the reasonable investor to take an investment decision without, or at very low, financial risk"[134]. The second such instance is "when the piece of information was such that it is likely to be exploited immediately on the market – i.e. that as soon as the information became known, market participants would trade on the basis of it"[135].

III. The information's pertinence, directly or indirectly, to one or more issuers or to one or more financial instruments. As previously mentioned, the Market Abuse Directive adds the qualification "directly or indirectly", which was not provided in the Insider Dealing Directive. This pertinence has to be ascertained on a case-by-case basis, taking into account all relevant circumstances as well as the "materiality of the event"[136]. The CESR offers a "non-exhaustive and purely indicative"[137] list of events, directly and indirectly concerning the issuer and financial instruments, which might amount to inside information[138].

IV. Price-sensitivity of the information. According to the provisions of Article 1 of the Directive 2003/124/EC, "…information which, if it were to be made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments shall mean information a reasonable investor would be likely to use as

[134] *Supra* note 130.
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] Thus, information directly concerning the issuer and financial instruments might be, inter alia, information related to operating business performance; information related to changes in control; changes in management and supervisory boards; any information related to the auditors activity; legal disputes, etc. Information indirectly concerning the issuer and financial instruments might be, inter alia, data and statistics published by public institutions disseminating statistics; the coming publication of rating agencies' reports; Central bank decisions concerning interest rates; competition and market authorities' decisions concerning listed companies, etc.

part of the basis of his investment decisions"[139]. The common European approach is to quit focusing on certain thresholds in determining whether the effect on prices is significant or not. Rather, a complex approach, based on an overall assessment of the case, is likely to lead to outcomes that are more precise. Factors, which should be considered, are the eventual magnitude of the particular event in the context of the company's activity, the reliability of the source, market variables that affect the price of securities in question, and others[140]. Indicators of the likelihood of the information's effect on the securities' prices are, among others, preexisting reports indicating that the type of information in question might haven impact on the securities' price; past instances of similar information having an impact on the securities' price[141]. Nevertheless, all these indicators are only very broad guidelines, as the impact of similar information on the securities prices will be very different depending on the particular company. Even within the same company, the impact of information might be different depending on the various classes of securities concerned.

The Market Abuse Directive retains the dual classification of insiders (which is not explicitly provided for in the Directive), into primary and secondary insiders. An additional category is added to the group of primary insiders, consisting of persons possessing inside information by virtue of their criminal activities. This is in line with international provisions relating to the fight against financing terrorist activities[142]. The definition of secondary insiders is slightly different from the definition used under the Insider Dealing Directive. There is no link between the primary insider and secondary insider. The Market Abuse Directive does not require any more that the source of inside information possessed by the

[139] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, Article 1.
[140] *Supra* note 130.
[141] *Id*.
[142] Recital (14) of the Market Abuse Directive states that "This Directive meets the concerns expressed by the Member States following the terrorist attacks on 11 September 2001 as regards the fight against financing terrorist activities".

secondary insider is a primary insider. In my opinion, this simplifies the application of the insider trading prohibition to secondary insiders, as the requirement for the identification of the original source of information was cumbersome, even unfeasible, sometimes. The actual definition also reaches a much broader range of persons than it used to reach under the Insider Dealing Directive. There is also a different approach to the subjective element of the secondary insider liability. Now it is necessary to prove only that the secondary insider "ought to have known" (instead of actual knowledge) that she possessed inside information. This seems to be a just requirement, as "actual knowledge" is very often difficult to be proved, making thus the secondary insiders somehow immune from the prohibition. The tipping prohibition, which initially was mandatory only relating to primary insiders, now extends to secondary insiders.

Finally, the insider trading prohibition itself has undergone a slight change in the wording of Article 2 of the Market Abuse Directive. There is no "taking advantage with full knowledge" requirement; instead, it suffices that the insider merely uses the inside information she possesses. It seems that primary insiders cannot defend themselves by claiming that they were not aware that the information they possessed was inside information (as was the case under the Insider Dealing Directive). Primary insiders are, as a rule, educated and informed persons, which have the duty to be aware of the type of information they come across during their activities. As far as persons becoming primary insiders by virtue of their criminal activities are concerned, in most cases, these criminal activities are committed purposefully; hence, the above-mentioned defense cannot apply to them either.

2.3 Insider Trading under the Moldovan Legislation

2.3.1. Overview of the Insider Trading Regulation in Moldova

In the Republic of Moldova insider trading is regulated by the Stock Market Law[143] (further on - SML). Article 3 of the SML provides the definitions of the concepts used throughout the Law. This Article defines the term "insider" as any person with knowledge of the issuer's privileged information. The definition of "privileged information" is an almost verbatim transposition of the definition of inside information under the Market Abuse Directive[144]. However, the core elements of the Moldovan insider trading regulation are to be found in articles 59 and 60 of the SML, under the heading of Title 4 of the SML "Investors Protection on the Stock Market".

The most striking feature of the insider trading regulation in Moldova is that there is virtually no insider trading prohibition. Insiders are allowed to trade, if several conditions are fulfilled[145]. Another important feature is that the law automatically grants the status of "insider" to certain categories of persons, regardless of their possession of inside information. I shall proceed to analyze the basic elements of the Moldovan insider trading regulation.

Who are insiders? The law does not distinguish between primary and secondary insiders. Article 59 of the Stock Market Law provides the following:

"Insiders are:

[143] Lege cu Privire la Piata Valorilor Mobiliare nr. 199 – XIV din 18.11.1998, Monitorul Oficial nr. 27-28/123 din 23.03.1999 (further on referred to as the Stock Market Law).

[144] According to Article 3 of the SML, privileged information is "information of precise nature which has not been made public relating, directly or indirectly, to one or more issuers or to one or more securities and which, if it were made public, would be likely to have a significant effect on the price of those securities or on the price of related derivative instruments".

[145] To be discussed later in this section

a) persons holding a job of responsibility within the issuer, including members of the issuer's supervisory and management boards, members of the issuer's censors' commission, as well as members of other administrative bodies of the issuer.

b) persons holding individually, or together with their affiliated persons, at least 50% + 1 out of the issuer's outstanding shares, bearing voting rights.

c) persons having access to the privileged information by virtue of their job, provisions of the contract or as a result of contract negotiations, or as a result of having been delegated this right by the issuer or by a issuer's insider.

d) natural persons, which belonged to the three aforementioned categories during the previous six months.

e) natural persons, affiliated to the persons specified at lit. a) – d)

f) in cases when persons mentioned at lit. b) and c) are legal persons, the statute of insider is also held by persons holding jobs of responsibility within these legal persons, as well as persons which by virtue of the exercise of their duties within the particular legal person, have access to the privileged information of the issuer.

g) any other person, possessing privileged information".

In this context, I would distinguish between insiders by the virtue of their status and insiders by the virtue of their possession of privileged information. The law establishes a presumption of possession of privileged information by virtue of status for an extremely broad range of persons. These are the members of the management and supervisory boards (Moldova follows the two-tier board model); members of the censors' commission (it controls the economical and financial activity of the company); major shareholders, whose holding exceeds a prescribed amount; natural persons which belonged to the aforementioned categories during previous 6 months; natural persons affiliated to the aforementioned categories; as well as natural persons holding jobs of responsibility with the aforementioned major shareholders – legal persons. In order to understand the real implications of this broad coverage, it is necessary to understand what an "affiliated person" means under the Moldovan law. In Moldova, the notion of "affiliated person" is a far-reaching one. In the case of legal persons, it includes members of the company bodies; persons holding jobs of responsibility within the company; legal or natural persons holding control within that legal person; affiliated persons of the abovementioned categories and others. In the case of natural persons, the notion of "affiliated persons" includes, inter alia, spouses and relatives until the second degree, legal persons within which the natural person holds a controlling position. These lists are longer[146]; those were just examples of the major categories of affiliated persons under the Moldovan law. Accordingly, bearing in mind the far-reaching definition of affiliated person, the actual number of insiders "by law" is overwhelming. According to some estimates[147], each Moldovan company has approximately 195 insiders. There are 3 000 Joint Stock Companies in Moldova. Therefore, the total number of insiders "by law" amounts to 585 thousand, which represents approx. 17,3 % of the Moldovan population. It has to be noted, that the abovementioned estimates do not include those persons, which retain the insider status for a period of 6 months after the cessation of the event that initially granted them that status (Art. 59, lit d)), as these numbers have to be assessed on a case-by-case basis. Thus, it seems like the actual number of insiders "by law" might be higher than the estimates. Once again, it has to be emphasized that for this type of insiders the law does not require any possession or use of privileged information. They become insiders merely by virtue of their status.

[146] For a definition of "Affiliated Persons", see article 3 of the Stock Market Law.
[147] Natan Garstea, "Insiders everywhere", unpublished article. Natan Garstea is the CEO of the Rating and Estimation Agency "EVM-MD". Between 1999 and 2003, Mr. Garstea was Counselor of the President of the National Securities Commission of Moldova.

The other group of insiders consists of persons who become insiders by virtue of their access to or possession of privileged information. Access to privileged information might be granted by virtue of:

- particular job. The law does not specify whether this has to be a job within the issuer. Therefore, any job giving access to privileged information suffices for this qualification. This provision covers public officials, journalists, Stock Exchange Board members and employees, issuer's lawyers and accountants (and eventually many other employees).
- contract (sales contracts, legal services contracts, audit services contracts, and many others);
- contract negotiations (this provision seems to cover persons which participated in the process of contract negotiations, regardless of the actual outcome of the negotiations);
- delegation of right by the issuer or issuer's insider (this provision might cover those cases, where access to privileged information was granted by power of attorney).

Elements of the Insider Trading Prohibition. The most important feature of the Moldovan insider trading prohibition is that there is no insider trading prohibition under the Moldovan law. Article 60, paragraph (1), of the SML provides the following:

"Insiders are allowed to buy or sell issuer's securities:

a) Through the means of public offer on the secondary market;

b) Without any public offer, provided that the following requirements are fulfilled:

  - The information provided in article 54, paragraphs (6) and (7), which can influence the price of the traded securities, has been disclosed prior to the transaction;

- The price of traded securities has been established according to the provision of Article 21, paragraphs (4) – (4^3)".

Article 54, paragraph (6) of the SML provides an exhaustive list of 13 events, deemed to affect the financial and economical activity of the issuer. Article 54, paragraph (7) of the SML provides the issuer's obligation to publish information related to these 13 events within 15 days form the date when such events occurred. Publication has to be made according to the provisions of the issuer's Articles of Association. Article 21, paragraphs (4) – (4^3) contains provisions related to means of determining the price of securities within a public offer[148].

Hence, the following two scenarios are available for an insider. According to the first scenario, any insider is allowed to trade if she makes a public offer for the securities under consideration. The futility of this provision is patently obvious. It establishes a cumbersome and useless procedure to be followed by those innocent insiders "by law" who are trading on the basis of public information. In case of "real" insiders, possessing privileged information, this provision allows them to trade as much as they want. For example, a member of the Supervisory Board of Company X possesses information regarding a potential takeover. Instead of being prohibited from trading, all she has to do is to register a public bid offer with the National Securities Commission and to start buying. The public offer requirement, implying that the insider will be obliged to buy (in this case) at a price established in accordance with some criteria, as mentioned above, does not protect market participants. The price will be established either on the basis of previous prices paid for the same securities, which by no means could have reflected the privileged information possessed by the insider

[148] Price will be determined either as the average price of transactions in those particular securities effected within 6 months prior to the registration of the public offer, or as the biggest price paid by the offeror or her affiliated persons for those particular securities within 6 months prior to the public offer registration. The highest price out of these two prices will be chosen. If there were no transactions effected in those securities during that time-span, the law provides other means of price determination, such as the value of net assets per share or estimation of price made by an estimation company.

at the moment she decides to trade, or on the basis of other criteria. In most cases, the price determined in the context of a public offer will be based on publicly available information and will not incorporate the privileged information known by the insider. Hence, in no way could such a price reflect the true value of securities traded by the insider, granting thus no protection to the innocent market participants.

Moreover, while the public offer requirement might place all the potential counterparties of the insider on an equal footing (as public offers should provide equal conditions for all potential counterparties), this requirement does not place the insider and her counterparties on an equal footing. Perhaps the requirement that a public offer should be valid for at least 30 days slightly increases the chances that during this period, privileged information will somehow become public, but this looks like a lottery game and legislation aiming at protecting investors should not rely on hopes.

According to the second scenario, in order to trade, the insider has to wait until the issuer makes public disclosure of any of the 13 events allegedly affecting the issuer's economical and financial activity. After this, the insider can sell and buy issuer's securities, at a price established in the same way as in the context of a public offer. This scenario seems to be more protective for the innocent investors than the first one, because at least in several instances the insider is obliged to wait for the disclosure before trading. Nevertheless, this provision has significant shortcomings. First, it provides an exhaustive list of events affecting the issuer's activity. However, the truth is that privileged information can relate to any aspect of the issuer's activity, as well as to the overall market situation; moreover, as mentioned in previous sections of this work, political news or virtually any other piece of information might amount to privileged information. Nevertheless, in Moldova, disclosure of the prescribed 13 events suffices for an insider to start trading. Thus, the bad-faith insider, possessing relevant privileged information that does not relate to any of the 13 events from the list, is allowed to trade freely on it.

Second, according to this scenario, disclosure has to be made by the issuer, and not by the insider. If an insider becomes aware of any information related to the list of events, she cannot disclose it herself and trade, but she has to wait for the disclosure to be made by the issuer. This requirement delays the conveyance of relevant information into the market.

As far as tipping is concerned, insiders are prohibited from tipping. The Moldovan tipping prohibition is a an almost verbatim transposition of the tipping prohibition of the Market Abuse Directive.

2.3.2. Comments

According to the above brief analysis of the Moldovan insider trading prohibition, the latter is blatantly different from modern models of insider trading regulations. First, it does not require a case-by-case analysis of each alleged insider trading. Instead, trading by certain prescribed categories of insiders is automatically caught under the Moldovan law. This amounts to a “presumption of guilt”. Moreover, insider trading as such is not prohibited, it is allowed under several conditions. As a result, innocent traders, which were attributed by law to the category of insiders, have to perform all their trades in securities in relation to which they are deemed insiders following a cumbersome a costly procedure. This requirement definitely diminishes their activity on the capital market and, perhaps, might decrease the overall stock market liquidity. On the other hand, true insiders, possessing inside information and willing to trade on it, can do it either under the conditions of a public offer, or after the issuer made the prescribed disclosure of an exhaustive list of events allegedly affecting the issuer’s activity. The Law also requires that in both cases the price of securities has to be determined according to prices of the same securities under prior transactions. This requirement serves no protective function for the ordinary investor, as the very meaning of inside information is that it has not yet been incorporated in the market prices. Therefore, previous market prices by no means can reflect the inside information possessed by the true insider and the latter finds no obstacles in reaping profits as a result of his trade.

The reasons behind this peculiarity of the Moldovan insider trading regulation might be multifarious. One of such reasons could be the powerful lobbying exercised by wealthy corporate insiders in the process of this law's drafting and adoption. The prohibition of insider trading has been virtually excluded from the Stock Market Law in 2005, generating many indignation and negative comments from the part of market participants. Nevertheless, even after the 2008 revision of the Law, no actual insider trading prohibition has been provided for.

Another plausible reason explaining the design of the insider trading regulation might be the inability of the executive branch to carry out and implement rules and regulations drafted by the legislative. Carrying out a case-by –case analysis of each element of inside information (such as its price sensitivity, non-public nature), proving that a particular person was indeed an insider and that her trade was effected on the basis of inside information, tracing all the alleged insider trading trades – all these activities require a lot efforts, skills and knowledge. Therefore, it proves easier to establish a general presumption, covering a vast majority of traders. In this context, a general insider trading prohibition would lead to a huge outflow of traders from the market. Hence, the Moldovan legislator chose what it considered the "middle way" – allowing insider trading, under several conditions. However, this approach is more detrimental than either of the two models: insider trading prohibition and absolute insider trading deregulation. Under the Moldovan regulation, the alleged beneficial effects of any of these two models cannot be taken advantage of.

CONCLUSIONS

This paper began by summarizing the longstanding debate over the policy need to regulate insider trading. The efficiency implications of insider trading were analyzed and a brief overview of the most prominent market and agency theories of insider trading was presented. The paper supports insider trading regulation, based on empirical studies and data showing the latter's efficiency both on the company's level and in the broad market context. Further, the paper analyzed major models of insider trading regulation, namely the US and EU models. The ultimate purpose of this analysis was to assess the core elements of modern insider trading regulations and to compare their implementation under the Moldovan law. The paper showed that under the Moldovan law there is virtually no insider trading prohibition. This triggers the detrimental consequences for the market and for the particular firm, which were examined in Chapter I of the paper. Nevertheless, Moldova availed itself also of the alleged benefits of the insider trading deregulation, because of the cumbersome procedure required for the insiders willing to trade. As far as investor protection is concerned, although placed under the heading "Investors Protection on the Stock Market", insider trading regulation in its current wording does not grant any protection for the ordinary investor. Thus, the actual state of the Moldovan insider trading regulation hampers the activity of the market.

There is also another aspect of the Moldovan insider trading regulation. The actual state of the Moldovan insider trading legislation undermines the investors' confidence and faith in mechanisms aimed at protecting them and ultimately undermines their faith in law as such. On the other hand, the "presumption of guilt" promoted by the insider trading regulation denotes a lack of faith and trust of the legislative body in its people. This yields a profound conflict within the society, with implications going beyond economic and legal parameters. "Faith in law…and faith in human beings – if you have those, you will be not only great lawyers, but great human beings as well"[149]. This might be a thing to keep in mind while drafting any regulation.

[149] Guido Calabresi, at http://www.law.harvard.edu/news/2007/06/12_calabresi.php

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