INSIDER TRADING IN THE UNITED STATES, CANADA AND THE UNITED KINGDOM

Susannah Lindenfield

Institute of Comparative Law

Faculty of Law

McGill University, Montreal

July 2000

A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements of the degree of Master of Laws (LL.M).

ABSTRACT

This thesis is a critical analysis of the law relating to insider trading in three common law countries. Chapter One, addresses the merits and demerits of the regulation of insider trading and presents a review of the academic literature relating to this field. In Chapters Two, Three and Four, the law of insider trading in the United States, Canada and the United Kingdom is analysed and discussed on a comparative basis. Each of these chapters is in two sections. The first section describes the regulatory system and institutions, and the second section discusses the regulation of insider trading, highlighting the critical elements of this type of regulation, such as the definition of an 'insider' and the scope of 'inside information'. It concludes with a broad discussion of the differing approaches of these countries to insider trading.

Cette thèse est un analyse critique du délit d'initiés dans trois pays 'common law'. Dans le premier chapitre, on discute les avantages et les inconvénients de la réglementation du délit d'initiés et la littérature academique rélatif à ce sujet. Dans les Deuxième, Troisième et Quatrième Chapitres on analyse et compare le droit concernant le délit d'initiés dans les Etats-Unis, le Canada et le Royaume-Uni. Chacun de ces chapitres comprend deux parties. La première partie décrit le système réglementaire et les institutions. La deuxième partie discute le droit du délit d'initiés et les éléments critiques de ce droit (par exemple, le définition d'initié et d'information privilegiée). La Conclusion discute les approches différents de ces trois pays quant au délit d'initiés.

ACKNOWLEDGEMENTS

I am grateful to my supervisor Professor Stevens for his guidance and insight and to Professor Smith and Ginette Van Leynseele for their practical assistance.

I am indebted to my mother and my stepfather Stuart for their moral and financial support, and to Damian for his patience and encouragement.

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CONTENTS

INTRODUCTION

It is thirteen years since financiers Ivan Boesky, Dennis Levine and, later, Michael Milken were arrested by the U.S. Federal Government for insider trading. That scandal, described as having "ended a decade of greed and opulence on Wall Street"[1], has been unmatched in recent years, the latest headlines relating to a ring led by a temporary worker at Goldman Sachs who found inside information by digging through waste paper bins.[2] No doubt regulators would like to attribute this noticeable lack of headlines to the deterrent effect of regulation which has been tightened in recent years. Perhaps there is some truth in that. Or perhaps insider traders these days are simply more careful. The latter hypothesis would better explain the frequent occurrence of share price movements in target companies prior to the announcement of a take-over bid.

Whatever the reason for the rather low profile these days of insider trading, this slippery practice is now the subject of sophisticated regulation in most countries. This thesis is a comparative study of the regulation of insider trading in the United States, Canada and the United Kingdom. In the first chapter the policy reasons for the regulation of insider trading are considered. In the following chapters the way in which each jurisdiction approaches the critical elements of insider trading law are addressed such as the scope of the definitions of 'inside information' and of 'insiders'. It concludes by questioning the value of criminalising insider trading and also suggests that the dramatically differing attitudes of the courts and the public in these three common law countries towards insider trading has more impact on enforcement success than any statutory inadequacies.

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[1] "Wall St insider trading is only small time now", Evening Standard (London), 20 March 2000.
[2] *Ibid.*

CHAPTER ONE: POLICY CONSIDERATIONS

I. INTRODUCTION

Insider trading is an interesting crime as it is one, like most white-collar crime, whose motivation can only be greed.[1] It is a crime committed generally by middle class professionals who simply cannot resist the temptation of acting on information which could make them richer or save them money. Whilst there may be an element of thrill involved the prime reason must be that insider trading is perceived to be an easy, low-risk way of making money that does not cause harm.

Insider trading as with other white-collar crime, is therefore not a typical crime, and the perpetrator is not a typical criminal. Criminologist Susan Shapiro writes:

> White-collar crime challenges the more banal kinds of explanations of criminal activity. To say that poverty "causes" crime, for instance, fails utterly to account for widespread lawbreaking by persons who are extraordinarily affluent. To suggest that criminals lack "self-control" similarly ignores offenders such as anti-trust violators and insider traders whose lives and achievements represent models of success through the exhibition of self-control.[2]

If insider trading is an atypical crime, should it be treated in the same way as other crimes? If not, should it be treated more or less severely? Edwin H. Sutherland who was one of the first to study white-collar crime considered that if anything, white-collar crime is more serious than other crime because it creates distrust and therefore is more damaging to society:

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[1] P. Tappen, *Crime, Justice and Correction*, (New York: McGraw Hill, 1960) at 7-10.
[2] S. Shapiro in G. Geis, R. Meir, *et al.*, *White Collar Crime: Classic and Contemporary Views*, 3rd Edition, (New York: The Free Press, 1995).

> The financial loss from white-collar crime, great as it is, is less important than the damage to social relations. White-collar crimes violate trust and therefore create distrust, which lowers social morale and produces social disorganization on a large scale. Other crimes produce relatively little effect on social institutions or social organization.[3]

Inevitably, due to the special nature of insider trading, its regulation has provoked widespread debate amongst regulators and academics alike. It has been argued by some that insider trading should be regulated for moral reasons, to preserve the integrity of the market and to protect issuers of securities. Others argue that it is not for lawmakers to dictate morality and that insider trading should be permitted because it improves the efficiency of the market and offers benefits to issuers.

II. THE POLICY DEBATE

The debate as to whether or not insider trading should be regulated began in the late 1960s following the publication of the book *Insider Trading and the Stock Market* by Professor Manne.[4] Up until then, the rule promulgated by the U.S. Securities and Exchange Commission (the SEC), rule 10b-5[5], which had been developed to restrain the practice of insider trading, had gone virtually unchallenged. Manne studied the effects of insider trading from an economics point of view and concluded that rather than be prohibited, insider trading ought to be encouraged as, according to his thesis, the practice was beneficial to both the securities markets and to corporations.

The response from academics and regulators alike was vigorous. Even Manne, who expected a "goodly amount of disagreement", was not prepared for the "emotional, almost hostile response" that his book received from some members of the academic community.[6] This chapter aims to summarise the main arguments advanced by Manne

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[3] E.H. Sutherland, "White-Collar Criminality" (1940) 5 American Sociological Review at 4.
[4] H.G. Manne, *Insider Trading and the Stock Market*, (New York: The Free Press, 1966).
[5] SEC rule 10b-5 17 C.F.R paragraph 240.10b-5 (1998).
[6] H.G. Manne, "Insider Trading and the Law Professors" (1970) 23 Vanderbilt Law Review 547 at 547.

and others against the regulation of insider trading and to put forward the key arguments that have been offered by regulators and academics alike, in favour of regulation.

A. Ethics

Lawyers usually start from the standpoint that insider trading simply is not fair. They see that it allows insiders to make a profit from confidential information and view it immediately in terms of a breach of trust. Moreover, they see the unequal bargaining positions of both parties to the trade which alone seems unethical and somewhat akin to allowing gamblers to play with loaded dice or marked cards.

Manne on the other hand, considered that any notion of fairness was misplaced when it came to the debate on whether or not to regulate insider trading:

> The "discovery" of ethical and moral issues and a recurrent insistence on this approach strike me more as an outgrowth of frustration than of cogent analysis.[7]

He was irritated by the insistence of his critics who put ethics ahead of economics. According to Manne, morality simply was not relevant to the debate:

> Morals, someone once said, are a private luxury. Carried into the arena of serious debate on public policy, moral arguments are frequently either sham or a refuge for the intellectually bankrupt. Just because the phrase "insider trading" raises a spector of dishonesty, fraud, exploitation, and greed is not sufficient basis for assuming that the fact must be so or that the practice must, ipso facto, be outlawed.[8]

But it is the "spector of dishonesty, fraud, exploitation, and greed" that concerned Manne's critics. One such critic, David Ferber, a lawyer at the SEC, stated his position as follows:

> I disagree with Professor Manne's basic position that "[t]he debatable aspects of insider trading are capable of resolution through tools of economic analysis," as

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[7] *Ibid* at 548.

> well as his "downgrading of morals." With respect to the latter, many if not most, laws on the books are based on concepts of morality. As I understand the Securities Exchange Act, its aim of preventing manipulative, deceptive, and fraudulent conduct in securities transactions was largely because of the congressional view that these activities were immoral. Under the securities laws Congress sought to have the securities markets honestly conducted.[9]

Ferber makes a valid point that many laws are founded in moral concepts. Anti-discrimination laws, for example, are largely an imposition of morality by the legislature on society. However, Manne believed that the preoccupation of his critics with morality was nothing less than irrational:

> Moral fervor, whether held by fundamentalist ministers or by law professors is not easily shaken by rational argument.[10]

Perhaps this may have been the case with some, but many critics simply believed that morality concerns were more important than economic ones. Professor Schotland for example, stated that the preservation of market integrity should not be displaced even if there was economic justification for insider trading:

> Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market and intracorporate relationships that satisfy such non-economic goals as fairness, just rewards and integrity.[11]

B. Insider Trading and the Securities Markets

1. Confidence

Arguments based on ethics were further justified on the basis that because insider trading damages the integrity of the markets it also damages investor confidence in the securities

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[8] *Ibid* at 549.
[9] D. Ferber, "The Case Against Insider Trading: A Response to Professor Manne" (1970) 23 Vanderbilt Law Review 621 at 621.
[10] *Supra* note 6 at 557.
[11] R.A. Schotland, "Unsafe at Any Price: a Reply to Manne, *Insider Trading and the Stock Market*" (1967) 53 Virginia Law Review 1425 at 1439.

markets. If investor confidence is adversely affected, the result is that fewer investors will go to the markets and those investors will pay less for securities in order to compensate for the perceived unfairness and uncertainty that results from insider trading.[12] Rider and Ashe explain this as follows:

> Public respect for the market and the function it performs will diminish where it is known or suspected the market unduly favours certain privileged individuals. For the same reason abuses such as insider trading and manipulation of prices will have a detrimental effect on the operation of the market. It is very important that each investor who comes to the market should feel that he is subject to the same degree of risk as everyone else in the market. It should also be emphasised that from the standpoint of investor confidence the mere suspicion that abuses occur or the allegation that the market is unfair is likely to be just as disruptive as proof that abuses have taken place. The reputation of the market as a fair and orderly market is critical.[13]

If investors are alienated from the market this will have adverse consequences for society as a whole regardless of the actual impact that insider trading may or may not have on the market. On this point, David Ferber writes:

> It is probably not susceptible to proof one way or another, except that, in the light of revelations of what had occurred in the twenties, the extent to which investors would have gone back to the markets may be questioned had they not thought that many of the manipulative devices then used had been made illegal.[14]

Professor Manne was far from convinced, except to the extent that he thought that the market confidence argument had been repeated so frequently that it had "gained a certain

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[12] This argument was put forward in the Kimber Report which is discussed in Chapter 3. See *Report of the Attorney General's Committee on Securities Regulation in Ontario* (Toronto: the Queen's Printer, 1965) (*Kimber Report)* at paragraphs 1-2.
[13] B.A. Rider and H.L. Ffrench, *The Regulation of Insider Trading*, (London: The Macmillan Press, 1979) at 6.
[14] *Supra* note 9 at 621.

currency" thus making it something of "self-fulfilling prophecy".[15] According to Manne, insider trading has no impact on investor confidence:

> We have no direct empirical measure of investor confidence in what the SEC terms the "integrity of the market", but the most relevant evidence on the subject (Benston) shows that investor participation in the stock market is exclusively a function of the recent performance of stock prices. If prices have risen, the public comes to the market, and if prices have tumbled, they depart.[16]

Others have argued that insider trading is not an unfair practice as its occurence is common knowledge and as a result prices are adjusted accordingly.[17] Whatever the justification, it is an argument that regulators have favoured and has been at the base of the policy behind most insider trading regulation.[18]

It is also argued that insider trading contradicts the principle of market egalitarianism, according to which every investor should have equal access to information. Manne rejects this argument stating that it is naive and that many investment decisions are made because the investor believes that he has superior information.[19] However, it does remain an aspiration of many policy makers, and was a guiding principle for the European Directive on Insider Dealing.[20]

Additionally, Schotland takes the view that to permit insider trading would be to encourage the unlawful manipulation of an issuer's stock:

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[15] H.G. Manne, *Economic Mysteries in Insider Trading* (Saarbrucken: Europa-Institut, 1991)(discussion paper) at 4.
[16] *Ibid* at 4.
[17] K.F. Scott, "Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy" (1980) 9 Journal of Legal Studies 801 at 807-9. See also D.W. Carlton and D.R. Fischel, "The Regulation of Insider Trading" (1983) 35 Stanford Law Review 857 at 857.
[18] See for example the Kimber Report, *supra* note 12 at paragraphs 1-2.
[19] B. Rider, *Insider Crime – The New Law* (Bristol: Jordans, 1993) at 5.
[20] EU, *Directive 89/592 of 13 November 1989 Co-ordinating Regulations on Insider Dealing*, [1989] O.J. L. 334/30.

> Allowing insider trading on undisclosed material information makes unlawful manipulation more likely. This is because it allows (and in the Manne thesis encourages) an insider to have an unusually large personal stake in the impact of public disclosure upon the price of his corporation's stock.[21]

Increased unlawful manipulation of the price of securities would be equally damaging to investor confidence for the reasons advanced earlier.

2. *Market Efficiency*

The main argument put forward in favour of insider trading is that it enhances market efficiency. Efficiency, as defined by Manne, means that new information relating to the issuer or the security is integrated speedily and accurately into the market price of a security:

> Efficiency in the stock market refers to both the speed and accuracy with which the market integrates new information into the market price of a security. All other things being equal, the more efficiently the stock market functions, the better off everyone is for many reasons. An efficient market is one in which capital will be allocated to its highest-return uses, thus ensuring that capital has long been recognized.[22]

Manne argues that insider trading aids the assimilation of information into the market price of securities because the insider's trading will have an effect on the price of the securities in which he trades. Theoretically, when the insider learns good news and buys securities there will be an increased demand for those securities. The increased demand means that the price of those securities will be pushed up. The opposite would occur when the insider learns bad news because by selling securities, the demand will fall and so will the price. Manne's theory is that as a result of the insider trading, the price of securities is more accurate and therefore the market operates more efficiently.

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[21] *Supra* note 11 at 1439.

The essence of Manne's thesis with respect to efficiency, is that insider trading causes a more rapid and accurate assimilation of information into the market than would otherwise occur.[23] This is beneficial for the following reason:

> Delays in the reflection of new information, or in the inaccurate reflection of information, must increase uncertainty in the market and thereby make beneficial trading more costly and less likely than would otherwise be the case.[24]

Let us consider the first contention, namely that information reaches the market place more quickly than it would otherwise. The theory is that the insider trades on the basis of information that has not been disclosed to the market place. Since his trading will affect the demand for the security and therefore its price, the information has an impact on the market place before its official disclosure.[25]

This theory is flawed. Whilst the effect of the information may reach the market before disclosure (provided that insiders trade in sufficient volume) it is likely that the actual information will reach the market later than it would otherwise. This is because insiders will have an incentive to delay disclosure of corporate information in order to give themselves the time to trade. Both Schotland and Ferber take this view.[26] According to Ferber:

> [I]f insiders were permitted to profit from inside information, there would be a natural tendency for insiders to prolong the period prior to disclosure.[27]

Moreover, according to Schotland insiders would be tempted to time disclosure in order to make a greater profit:

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[22] *Supra* note 6 at 565-6 (footnotes omitted).
[23] *Ibid* at 565-575.
[24] *Ibid* at 566.
[25] *Ibid* at 566-568.
[26] D. Ferber, *supra* note 9 at 623 and R.A. Schotland, *supra* note 11 at 1448-9.
[27] *Supra* note 9 at 623.

> If we abandon restraints on insider trading, we tempt insiders to delay disclosures so that they can buy more shares or arrange financing for more buying; we also invite the timing of disclosure to get the maximum market response.[28]

Manne however, contends that there will always be a time lag between the development of new information and its ultimate publication to outsiders, even if there is perfect compliance with a rule against insider trading.[29] It is preferable therefore for the effect of information to be absorbed in the meantime. In any case, according to Manne, insiders would not be keen to delay disclosure as the sooner it occurs the quicker a profit can be made.[30] Manne further argues that rather than delay disclosure, insiders are more likely to speed up disclosure in order to register their trading gains, as the faster insiders can move in and out of the stock, the higher will be the rate of return on any given investment.[31] Logically though, there must be at least some delay while the insider organises his trading. During that time, the insider withholds information, so the implications of that information cannot be fully reflected in market prices. As a result, according to Mendelson, the "allocative function" of the capital markets is impaired:

> If the capital markets are to allocate resources efficiently, the prices of securities must reflect, as accurately as possible, the prospects of the corporate issuers. If information bearing on those prospects is withheld, the implications of that information cannot be reflected in market prices, and the allocative function of the capital markets is impaired.[32]

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[28] *Supra* note 11 at 1448-9.
[29] *Supra* note 6 at 566.
[30] *Supra* note 6 at 568.
[31] *Supra* note 15 at 4.
[32] M. Mendelson, "The Economics of Insider Trading Reconsidered" (1969) 117 University of Pennsylvania Law Review 470 at 473.

Manne's second contention is that information is absorbed into the market more accurately. This is so, it is argued, because insiders are in a good position to determine the true value of information to the corporation:

> The point most simply stated is that insiders are generally in the best position to weigh new information accurately and assess its future impact on market price.[33]

This places insiders in better positions than even the best analysts:

> True, a good securities analyst may discover much of this information, but equally true, he will rarely be in the same position as insiders to assess all the relevant factors. Furthermore, information can be processed and acted upon much more quickly by an insider than by the public, and, of course, the insider can hire outside expertise as well as the next man.[34]

Because insiders trade on the basis of accurate information, ultimately that accurate information will be reflected in the price that will have responded to the insider's trades:

> Perhaps the central economic argument in favor of allowing insider trading is that such trading always pushes the price of the stock in the "correct" direction. That is, insiders' purchases will only be made when good news has developed and sales made only when there is bad news. To the extent that the insider's transaction has any effect on share price, it will always be to push up the share towards equilibrium point. Thus insider trading always contributes to the efficency of the stock market.[35]

It is also argued that insiders trade on information that is not by its nature 'disclosable' information. For example, the insider may be party to information about developments in the management of a corporation, such as any personal animosities that may have developed. The insider may know from his knowledge of the corporation that this could

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[33] *Supra* note 6 at 569.
[34] *Ibid* at 573.
[35] *Supra* note 15 at 5.

affect the corporation's prospects. However, that kind of information may not lend itself to disclosure. Theoretically therefore, non-disclosable information can also be assimilated into the market if insider trading is permitted.[36]

The importance of the assimilation of information via insider trading lies in the fact that market prices will not be subject to large fluctuations. As insiders trade, the market will react to their selling or buying. The price of the security will therefore move in the right direction. By the time (if at all) the information is actually disclosed, the price of the security will already have reacted to the information. Therefore there should be no significant jump in price when the rest of the market responds to the newly disclosed information. Thus the market is less volatile as a result of what Manne calls the 'market-smoothing effect' of insider trading.[37]

These arguments have by no means been universally accepted. First, it is certainly debatable that insider trading has any impact on price. The volume of trading would have to be very large for the price of the security to be affected, and the market would respond to any high volume trading, whatever its cause may be. Thus it cannot be said that the market is absorbing information, since it would react in the same way if the trading were motivated by a whim.

Secondly, if the market does react to the trading, effectively mispricing is occurring. Schotland argues that this implies that the capital markets themselves may be malfunctioning. If so, insider trading alone could not contribute to proper adjustment and 'correct' the price.[38] The only way that the market can really absorb information is through disclosure by the corporation.

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[36] *Supra* note 6 at 573.
[37] *Ibid* at 574.
[38] *Supra* note 32 at 475.

Third, even if insider trading could cause gradual price movements, this may not necessarily be beneficial to the market. On the contrary, Schotland maintains that a market characterised by sharp shifts as a result of informed transactions is preferable to one characterised by many uninformed transactions. In his words the "smoothness" that might be gained is not worth its cost.[39]

Finally, Manne offers one other argument. This is that since any prohibitions against insider trading cannot be perfectly enforced, such prohibitions will not act as a deterrent. Insiders will still trade in spite of regulation. The only effect of regulation will be that insider trading becomes more difficult. Consequently the insider will expend time avoiding compliance and circumventing the rules. During this time disclosure will be delayed and the stock market will suffer:

> ...[P]erfect enforcement is not possible ... therefore subterfuges and devices to circumvent the rule against insider trading will be discovered and utilized. Of necessity these devices will consume time, and to the extent that time is expended in order to avoid compliance with the ... rule, all other individuals who benefit from an efficient stock market are injured.[40]

This argument is unacceptable for several reasons. First, as with all crimes, enforcement can never be totally effective. However, the fact that enforcement is difficult or inefficient is not a justification for the elimination of an act's criminal status. Such inadequate enforcement should merely stimulate debate about preferable policing methods. Secondly, it is not the case that poor enforcement will necessarily destroy the impact of regulation as a deterrent. David Ferber writes:

> Even though some persons will necessarily get away with trading on the basis of inside information, just as undoubtedly the Commission is unable to catch up with all persons who sell securities through fraudulent means, the fact that the

[39] *Supra* note 11 at 1446.
[40] *Supra* note 6 at 567.

> Commission is able to enforce the law against some violators necessarily discourages many other would-be violators.[41]

This must be so. Indeed some people will be deterred by the very fact that insider trading is a crime, regardless of whether it is enforced, simply because they do not want to break the law.

C. The Issuer

Those in favour of regulation argue that insider trading is harmful to issuers because employees' personal interests will conflict with the corporations if they are permitted to trade in the employer corporation's securities. This is because the judgment of the employee insider may be affected as to the timing of certain events which may impact upon the price of the corporation's securities. An insider may even be tempted to cause events that are not in the interest of the corporation so that his personal trading profits are increased:

> If insiders are free to trade on undisclosed material information, they are subject to a conflict of interest that may affect their judgment not only in the timing of disclosure, but also in the timing of the underlying events themselves. Still worse, the insiders' interest in personal trading profits not only may affect their judgment in the timing of underlying events, but also may cause such events to be created – for example, a dividend might be declared when sound business judgment would have omitted it.[42]

This contention seems to be valid and if so, insider trading represents a serious risk for any corporation.

Winslow and Anderson make an analogy with baseball and the prohibition of gambling by players. They explain that the reason for the prohibition is to ensure that players' incentives are not altered:

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[41] *Supra* note 9 at 621.

> While concerns such as maintaining its good reputation have led the Major League to forbid betting on any baseball games, the primary objective of the gambling prohibition is to maintain the actual integrity of the game....In essence, this reflects a perceived need to prevent betting that can alter a player's incentives, and thus performance, in a given game.[43]

They consider this situation to be broadly the same as the prohibition of insider trading by employees of corporations who would be given a perverse incentive to trade on negative corporate developments.[44]

There is also an argument, perhaps more tenuous, that employees will be distracted from their duties to the company by their personal trading interest.[45] According to Schotland:

> The pursuit of personal trading profit is likely to distract the insider from the pursuit of corporate tasks, for which the corporation presumably is paying full, adequate compensation already and expects full, single-minded dedication in return.[46]

Certainly if insider trading profits prove to be more lucrative than an employee's salary, this might be problematic. However, profit resulting from insider trading is likely to be of a windfall nature since news important enough to drive up the stock price will be infrequent and erratic.

Others however, consider that insider trading cannot be harmful because if it was the private sector would have moved to regulate it.[47] Haft disagrees, and asks who would

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[42] *Supra* note 11 at 1452.
[43] D.A. Winslow and S.C. Anderson, "From "Shoeless" Joe Jackson to Ivan Boesky: A Sporting Response to Law and Economics Criticism of the Regulation of Insider Trading" (1992-3) 81 Kentucky Law Journal 295 at 297.
[44] *Ibid* at 300.
[45] *Supra* note 11 at 1452.
[46] *Ibid.*
[47] D.W. Carlton and D.R. Fischel *supra* note 17 at 858-60.

move corporations towards an insider trading ban? He suggests that the chief executive and the board of directors would have to "voluntarily eliminate their own potentially immense profits" if they were to demand such a ban.[48]

Haft also argues that aside from the perverse incentives that allowing insider trading would bring, there is a risk that the 'team' culture of the corporation would be damaged as employees would be acting in their own interests and not those of the team and therefore the corporation:

> Organisational efficiency is usually ... promoted by the cohesiveness of the unit to which decision-making is delegated. ... And, ... if the members of the unit choose to capture such profits individually rather than cooperatively, work groups will become less cohesive and the quality of their decisions will fall.[49]

However, arguments have also been advanced to the effect that insider trading actually benefits issuers. This is supposedly so because insider trading provides a "meaningful form of compensation in large corporations for the entrepreneurial function".[50] Manne describes this as his "principal affirmative argument for insider trading".[51]

The theory is that if insiders trade on information which they obtain through working for the corporation they will effectively be receiving additional compensation from the corporation in the form of their trading profits. This provides an incentive to remain with the company and to work hard.[52] Furthermore the cost to the corporation is minimal, if anything:

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[48] R.J. Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1981-2) 80 Michigan Law Review 1051 at 1058.
[49] *Ibid* at 1056.
[50] *Supra* note 6 at 578-9.
[51] *Ibid* at 578.
[52] *Ibid* at 582.

> There will be no important loss to shareholders if insiders do trade on [good or bad] news, and it will be possible, in an inexpensive way, to give entrepreneurs within the corporation a greater opportunity for gain.[53]

Manne also argues that compensating employees in this way encourages them to create good news. Consequently, employees bring value to the corporation and are rewarded in proportion to that value. When the employee is working well and is therefore generating 'good news' about the company, that employee can trade on the good news and make a profit. Trading on bad news will only allow an employee to avoid a loss. Thus creating good news is more lucrative than creating bad news. The employee therefore has an incentive to create good news, and his contribution is valued and remunerated accurately.

The obvious argument against this is that insider trading simply cannot be confined to those 'creating' the good news. The nature of insider trading is such that anyone with knowledge of inside information can benefit, whether this be a lazy or a diligent employee. Furthermore, the benefits of insider trading are spread to those outside of the corporation since the lazy employee could easily communicate the information to friends, or even sell it. As Schotland puts it the "ineluctable fact is that the use of confidential information, if permitted at all, cannot be kept from running rampant".[54] It will not therefore necessarily be the diligent employee who is compensated by the information.

Moreover, the amount of profit an insider trader can make simply depends on the resources available to him. Thus, the lazy employee's rich friend will make more profit than the diligent employee. Insider trading therefore cannot be said to offer an accurate and fair form of remuneration. It is access to information, not ability or contribution, which determines whether or not the employee is compensated. In addition to this it is

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[53] *Supra* note 4 at 155.

ludicrous to suggest that an employee should be free to evaluate his own compensation. On this point Schotland states:

> To free the entrepreneur form any and all bargaining over the amount of his compensation – to keep him in the corporate structure, but answerable to no one for what he earns from it – would be a revolutionary aberration of our corporations law and economics. It rests on a neo-Nietzschean reverence for the outstanding individual and is utterly contrary to the way we run what some have called "people's capitalism".[55]

Additionally, insiders who may have created bad news should not be able to "ease out of their investment while the stockholders stand holding the bag".[56]

Manne also suggests that if managers were allowed to trade on inside information they would take more risks than they would if they were rewarded by salary alone. This is apparently so because greater variability in the company's stock price would provide more insider trading opportunities, whereas compensation in the form of salary alone creates substantial risk averseness on the part of managers:

> Salary will always make managers more risk averse than will compensation that makes them residual claimants. Both bonuses and stock option plans have been adopted in an effort to deal with this problem, but neither of them can completely capture the incentive characteristics of allowing trading on new information.[57]

It is questionable whether this really offers a corporation any benefit, since it may not be desirable for managers to take risks. If corporations did want to encourage risk-taking by managers, there are other ways of achieving this goal.

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[54] *Supra* note 11 at 1425.
[55] *Ibid* at 1455.
[56] *Ibid* at 1453.

Finally, Manne asserts that those managers or employees who are trading for their own accounts are in fact 'entrepreneurs':

> Since they have the most to gain thereby, the individuals receiving information will already have or will eventually gain some power to encourage new developments. This, I take it, is the quintessential function of the entrepreneur in classical theory...[58]

As well as offering a contribution to society with their wealth creation, these entrepreneurs benefit the corporation: clearly a corporation replete with entrepreneurs is a healthy and vital one. The flaw of this argument is of course that the so-called entrepreneurs are acting for their own accounts and this is not necessarily beneficial to the corporation itself. To even describe insider traders as entrepreneurs is probably inaccurate as they do not create value. Rather, insider purchasing is "an attempt to capture unrecognized value".[59] The price of the corporation's stock would respond to purchases by an insider whether he had information or not. There is nothing particularly entrepreneurial about an insider who trades securities on the basis of a 'sure thing'.

D. Harm

Another common argument against regulation is that no-one is harmed by insider trading as there is no discernible victim since transactions take place on the open market place between willing buyers and sellers. According to Manne, no-one with "an important interest is being deprived of his interest when insiders are allowed to trade"[60]. The belief that insider trading is a 'victimless crime' stems from the fact that there is no discernable element of fraud because the insider does not induce the other party to the transaction to trade. That other party would have bought or sold anyway. Indeed the outsider in general might be advantaged rather than disadvantaged by the trading. At best, the effect of the insider's trades might be to push up the price of the securities from which selling

[57] *Supra* note 15 at 5.
[58] *Supra* note 6 at 583.
[59] *Supra* note 32 at 482.

outsiders would benefit. At worst, insider trading would only cause a shift of wealth from one group of uninformed outsiders to another.[61] Manne states that even if there were a loss to outsiders "it is not necessarily an overall economic loss to the community".[62] According to Manne, to reach that conclusion would "require the absurd assumption that insiders gain less than outsiders as a group lose".[63]

Professor Mendelson disagrees. He argues that there is damage to outsiders because insiders as a group will always make more profit than outsiders as a group will:

> A principle characteristic of an equity security is the uncertainty of the return the investors are going to realize from it. Because of the high degree of risk that does in fact obtain in the case of equities, investors expect a high rate of return. But when insider trading is profitable, outside investors only partially share in the good fortunes of the company, while losses are accentuated.[64]

On the basis of this analysis, outsiders therefore do suffer as a group.[65]

E. The Approach of the Common Law

Two main theories have been advanced at common law to justify the prohibition of insider trading. The first is that insiders may be under a fiduciary duty not to use inside information and the second is that the issuer may have proprietary rights over inside information.

1. Fiduciary Duties

a) The British and Canadian Courts

In the United Kingdom and Canada, there is in fact no general principle of liability for insider trading at common law per se. Some attempts have been made however to show

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[60] *Supra* note 4 at 110.
[61] *Supra* note 15 at 4.
[62] *Supra* note 4 at 103.
[63] *Ibid* at 104
[64] *Supra* note 32 at 477.

that an insider breaches fiduciary type duties owed to the company when he trades in his company's securities on the basis of inside information.

Theoretically, the breach by the insider fiduciary may be founded on two bases. The first is that it is a fundamental rule of equity that a fiduciary may not place himself in a position where his personal interest and duty conflict. Thus, when an insider fiduciary trades on the basis of information about the company for his own account, there may be a conflict as the insider may make corporate decisions which are not necessarily in the interests of the company, but which may be profitable for the insider. The second is that a fiduciary may not make a secret profit. By trading on inside information the fiduciary insider is making a profit derived from the company.

Indeed, in early cases, the common law did address insider trading from the point of view of fiduciary duties since most cases involved insider trading by directors. Directors have historically been considered to occupy a clear fiduciary role. Indeed in some cases, analogies were made with trustees, and directors' responsibilities towards their companies were considered to be akin to those of trustees.[66] Later cases saw directors being described as 'agents'[67] and in some instances as 'managing partners'[68] of their companies. Whilst the importance of the analogy lay in establishing a trustee type of relationship so that proprietary remedies would be available, the essence was that directors were considered to have very clear duties to the company which were of a fiduciary nature.

As the doctrine of corporate personality developed it became established by the courts that in so far as directors owed fiduciary duties these were only to the company and not

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[65] *Ibid* at 477-478.
[66] For example, *Wallworth v. Holt* 4 Ma Cr 619; *Charitable Corporation v. Sutton* (1742) 2 Atk.400; *The Great Luxembourg Railway Co. v. Magnay (No. 2)* 25 Beav. 586.
[67] For example, *Ferguson v. Wilson* (1886) L.R. 2 Ch. 77 at 89 and *Cargill v. Bower* (1878) 10 Ch. D. 502.
[68] See *Automatic Self-Cleaning Syndicate Co. Ltd v. Cunningham* (1906) 2 Ch.34 at 45.

to shareholders as individuals.[69] This presented a problem in terms of establishing liability for insider trading by directors. In the landmark decision of *Percival v. Wright* this was taken to mean that directors could make use of inside information for their own trading purposes. [70] The judgement, rendered by Swinfen Eady J., was much criticised.

In *Percival v. Wright*, the shareholders of the company approached the directors and asked if they knew of any prospective purchasers for their shares. The shareholders set the price and the directors bought the shares from the shareholders. However, the directors failed to disclose to the shareholders that there were negotiations in place for the sale of the company's undertaking, a fact that would have put the value of the shares much higher.

Swinfen Eady J. found that the directors were under no duty to disclose the information about the negotiations to the shareholders as their duties were to the company alone:

> I am therefore of the opinion that the purchasing directors were under no obligation to disclose to the vendor shareholders the negotiations that ultimately proved abortive. The contrary view would place directors in a most invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company. I am of the opinion that directors are not in that position.[71]

Interestingly, Swinfen Eady J. emphasised that the directors did not approach the shareholders and therefore there could be "no question of unfair dealing".[72] One wonders whether the case would have been decided differently had the directors approached the shareholders.

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[69] See B.A. Rider and H.L. Ffrench, *The Regulation of Insider Trading*, (London: The Macmillan Press, 1979) at 147.
[70] *Percival v. Wright* (1902) 2 Ch. 421.
[71] *Ibid* at 426.
[72] *Ibid* at 426-7.

In *Regal (Hastings) Ltd. v. Gulliver*[73] the British courts also took the view that the directors were bound by fiduciary duties to account for profits made by virtue of their position. In the latter case, per Viscount Sankey:

> ... the respondents were in a fiduciary position and their liability to account does not depend on proof of *mala fides*. The general rule of equity is that no one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interest of these whom he is bound to protect. If he holds property so acquired as trustee, he is bound to account for it to his *cestui que trust*.[74]

The House of Lords took the approach that the only consideration was whether the insider directors' profit had resulted from their fiduciary position:

> At all material times they were directors in a fiduciary position, and they used and acted upon their exclusive knowledge acquired as such directors. They framed resolutions by which they made a profit for themselves. They sought no authority from the company to do so, and, by reason of their position and actions, they made large profits for which, in my view, they are liable to account to the company.[75]

And per Lord Russell:

> ...I am of the opinion that the directors standing in a fiduciary relationship to Regal in regard to the exercise of their powers as directors, and having obtained these shares by reason and only by reason of the fact that they were directors of Regal and in the course of the execution of that office, are accountable for the profits which they made out of them.[76]

Their Lordships were concerned clearly with the fact that the directors had breached their fiduciary duties to the company and had made a secret profit and thus should account for that profit to the company. Of course this still would not provide a remedy for a

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[73] *Regal (Hastings) Ltd v. Gulliver* (1942) 1 All E.R. 378.
[74] *Ibid* at 381.
[75] *Ibid* at 382 per Viscount Sankey.
[76] *Ibid* at 389.

shareholder who had lost out by selling a director his shares, but at least under this theory directors were not at liberty to freely trade on inside information.

In a later case involving insider trading by trustees rather than directors, considerable importance was placed on the fact that the inside information and the opportunity to acquire it came by virtue of the privileged position of the trustees. Per Lord Hodson:

> The proposition of law involved in this case is that no person standing in a fiduciary position, when a demand is made on him by the person to whom he stands in the fiduciary relationship to account for profits acquired by him by reason of his fiduciary position and by reason of the opportunity and the knowledge, or either, resulting from it, is entitled to defeat the claim on any ground save that he made profits with the knowledge and assent of the other person.[77]

In a Canadian case however, the courts of Ontario, whose decision was affirmed by the Privy Council, found that directors could be bound by fiduciary duties to shareholders in special circumstances. Such circumstances or 'special facts' were essentially when directors become agents for selling shareholders although in this case there had been fraudulent representations by the directors.[78]

b) *The American Courts*

Whilst in England and Canada common law remedies in respect of insider trading became supplanted by specific statutory remedies justified largely on the basis of the market confidence argument, in the United States case law developed on the basis of the so-called misappropriation theory. This theory is discussed in detail later, but is worth considering briefly in the context of fiduciary liability for insider trading.

The justification of regulation under the misappropriation theory, as has been developed by the courts in the United States, is that insiders misappropriate information belonging

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[77] *Boardman v. Phipps* (1966) 3 All E.R. 720 at 744.
[78] *Allan v. Hyatt* (1914) 30 TLR 444.

to the company. Of course the theory is also a proprietary theory but the importance of the fiduciary relationship is paramount.

The theory is that if insiders are involved in fiduciary like relationships they should not use confidential information obtained by virtue of such relationships. According to this theory, not only are directors and lawyers in fiduciary-like relationships, but virtually anyone who is bound, explicitly or impliedly, by a duty of confidence is also caught. Thus, a printer who proofs prospectuses, or a cleaner who cleans the offices of a law firm, cannot use information obtained by virtue of their jobs. Under this theory, the duty of confidence is not necessarily to the issuer of the securities. Instead the duty is usually owed to the employer. In fact the duty is owed to the issuer from whom the information has been wrongly appropriated. Once breach of that duty has been established, liability is extensive and is not limited to recovery by the company as a secret profit. In fact, shareholders can recover and significant civil, administrative and criminal penalties can be imposed. The misappropriation theory has recently been approved by the Supreme Court.[79]

2. *Proprietary Rights*

As has been noted, in the United States information is treated as property. This means that the owner of such information may have proprietary rights over it. The theory is that if the insider then uses that confidential information which is owned by the issuer, the issuer suffers damage. This argument was advanced in 1961 by the SEC in an opinion in *Cady, Roberts & Co.*[80].

In *Cady* the SEC argued that "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" was a reason for a prohibition against insider

[79] *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

trading.[81] The SEC considered therefore that insider trading deprived the issuer of property rights. Manne rejected this theory outright and stated:

> For some writers the moral argument seemed to be substantiated simply by changing the terminology. To this group, insider trading must be outlawed because the information is the "property" of the shareholders ... For them the ukase that the information does not belong to the insider but rather is the property of the shareholders seems to satisfy all demands of logic.... One is certainly tempted to suggest that by now intelligent lawyers would realise the emptiness of that position. They should recognise that the concept of property is no more nor less than the rights and obligations recognized by law ...[82]

Whilst property arguments do seem at first to offer justification for insider trading regulation, on further consideration it is apparent that they do not adequately justify the prohibition of all types of insider trading. This is because not all kinds of inside information can be described as being the property of the issuer. Inside information suffers from the same problem as ideas do when attempts are made to protect them in intellectual property law. Often inside information is imprecise and its origin may not relate to the issuer. For instance, it cannot be said that the knowledge of the impending take-over of a target company derived from the predator company belongs to the shareholders of the target company. In this situation, if anything, that information is owned by the predator company, but it is the shareholders of the target company who will suffer if an insider of the predator company purchases shares in the target company. However, property type arguments have continued to appear in some American cases.[83]

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[80] *In re Cady, Roberts & Co.* 40 SEC 907 (1961).
[81] *Ibid* at 912.
[82] *Supra* note 6 at 550.
[83] For example, *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), aff'd in relevant part by an equally divided Court, 484 U.S. 19 (1987).

F. Conclusion

Despite the vigorous debate inspired by Manne, the general consensus of academics and regulators alike now seems to be in favour of regulation. British and Canadian regulators tend to justify regulation on the basis of the equal access to information theory claiming that without equal access to information investors will be discouraged from trading and thus confidence in the markets will be damaged. American regulators also adopt this view although, as has been noted, the courts have also justified the prohibition of insider trading on the basis of fiduciary and proprietary arguments.

To the extent that such policy reasons for sanctioning insider trading can be criticised, it is now difficult to get away from the fact that insider trading is perceived to be unethical or that investors would prefer to invest in a market in which insider trading is regulated. It does not seem objectionable that governments should encourage high standards of ethics in the stock market through regulation. This can only be of benefit to society even if investments made in the stock market are inherently risky. Without the regulation of unfair practices such as insider trading, investment in equity securities would be perceived as high risk and some investors would be deterred. Ultimately corporations would lose a valuable means of raising capital and the stock markets would be damaged.

CHAPTER TWO: INSIDER TRADING IN THE UNITED STATES

I. THE REGULATORY STRUCTURE

The law relating to insider trading in the United States is an amalgamation of statute, SEC rules and interpretation by the courts. As a result it has been in a constant state of flux and has been subject to a degree of uncertainty.

Securities regulation in general falls within the domain of federal law although state law does have some relevance, notably in so far as the 'Blue Sky Laws' (discussed *supra*) apply.

A. Federal Legislation

1. Overview

Federal securities legislation was developed following the stock market crash of 1929. Two broad statutes were enacted: the Securities Act of 1933[1] (the "Securities Act") and the Securities Exchange Act of 1934[2] (the "Exchange Act") which remain today the foundations of securities law.

The Securities Act regulates the issue and registration of securities. All securities that are offered to the public, by means of the mails or other media of interstate commerce, must be registered. The sale of securities that have not been registered is prohibited unless the securities fall into an exempt category set out in the Act. The Securities Act also requires that a prospectus be delivered to all purchasers and offerees of securities containing detailed information about those securities and the risks involved in purchasing them.[3]

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[1] *Securities Act* of 1933, 16 U.S.C. s. 77a (Law Co-op., 1996) [hereinafter the Securities Act].
[2] *Securities Exchange Act* of 1934, 15 U.S.C. s. 78a (Law Co-op., 1996) [hereinafter the Exchange Act].
[3] See generally L. Loss and J. Seligman, *Fundamentals of Securities Regulation, 3rd edition*, (Boston: Little, Brown and Company, 1995) at 35 [hereinafter Loss].

The Exchange Act governs conduct in the exchange of securities, such as matters relating to disclosure and fraud. It also created the Securities and Exchange Commission (the SEC) which is the federal securities regulator.[4]

2. *The SEC*

The SEC is composed of five commissioners who are appointed by the President on the advice of, and with the consent of, the Senate. Each commissioner is appointed for a five year term and is prohibited from undertaking any other business, employment or vocation whilst in service. The SEC is autonomous and non-partisan: not more than three Commissioners can be members of the same political party.[5]

It is made up of four main divisions including the Division of Enforcement, which investigates possible violations of federal securities laws. Enforcement action is taken either in administrative proceedings or by seeking injunctions and civil penalties in the federal court. Although it is not itself authorised to bring criminal proceedings, the SEC co-operates closely with the Department of Justice and U.S. Attorney's offices.

The SEC is responsible for administering seven securities statutes including the Securities Act and the Exchange Act. Its primary responsibilities are to ensure that the securities markets are fair and honest and to ensure that issuers provide investors with adequate disclosure about their company and securities. The SEC achieves this by issuing rules and by supervising market participants.

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[4] The SEC was created under section 4(a) of the Exchange Act *supra* note 2.
[5] *Ibid.*

a) Rule Making

The SEC has the power to supplement the federal securities statutes by creating rules that may be general or specific.[6] Each securities statute empowers the SEC to make such rules and gives those rules the force of law.[7] The SEC also makes law by pursuing particular enforcement strategies on a case by case basis. It also issues interpretative releases and non-binding "no-action" letters to indicate policy and makes these publicly available.

b) Supervision

The SEC is charged with the supervision of the various self-regulatory organisations (SROs) in the United States. There are four types of SRO: national securities exchanges, (e.g. the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex)); national securities (e.g. the National Association of Securities Dealers (NASD)); registered clearing agencies; and, the Municipal Securities Rulemaking Board.[8]

The Exchange Act granted the SEC broad authority to regulate the SROs. Section 5 of the Exchange Act requires that SROs register with the SEC and also requires that the rules adopted by SROs be first submitted to the SEC for approval. Section 9(c) of the Act empowers the SEC to amend or revise any rules made by SROs.[9]

The SROs themselves have broad disciplinary authority over their members. They benefit from being able to issue general, principled rules which may be interpreted widely as they are essentially private bodies. Thus, conduct which may comply with the letter of the law but which nonetheless constitutes market misconduct can be sanctioned. Moreover, sanctions can be heavy. Sanctions at the NASD for example, comprise fines,

[6] See L. D. Soderquist and T. A. Gabaldon, *Securities Law*, (New York: Foundation Press, 1998) at 13.
[7] For example, section 32(a) of the Exchange Act *supra* note 2 and section 24 of the Securities Act *supra* note 1.
[8] See Loss *supra* note 3 at 34-35.

censure and suspension of members from supervisory positions or even from the industry.

B. State Legislation

State securities law has become known as 'blue sky' legislation since the first statutes were enacted to combat fraudulent promoters who it was believed would sell fee simple estates in the 'blue sky' itself. The first was enacted in Kansas in 1911 and since then each state has adopted its own 'blue sky' laws.

Blue Sky laws initially empowered state administrators to ban any issues of securities that were deemed to be unfair or to represent too high a risk for investors. The philosophy behind the 'blue sky' legislation has therefore been described as merit based. This differs in principle from the approach that has been taken by federal legislators which, rather than ban individual issues or types of issue, imposes an obligation on issuers to disclose certain information about securities sold. More recently states have been moving towards disclosure systems instead of the merit-based approach or have at least tempered the powers of state regulators. The disclosure approach offers investors more choice, allowing them to purchase high-risk securities if they are so inclined. A merit-based system would prohibit such sales and for this reason has been criticised.

II. THE REGULATION OF INSIDER TRADING

A. Introduction

Insider trading conflicts fundamentally with the disclosure philosophy that is the foundation of federal securities regulation. It is therefore unsurprising that the United

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[9] See J. M. Bartos and F. E. Dangeard, *United States Securities Law: A Practical Guide*, (Deventer: Kluwer Law and Taxation Publishers, 1992) at 104-5.

States has pioneered anti-insider trading law and that the SEC has consistently taken a strong enforcement stance. [10]

With the exception of section 16(b) of the Exchange Act (which regulates short-swing profits by certain insiders) and various other enforcement provisions, no statutory provision deals explicitly with insider trading. Instead liability has been headed under the 'catch-all' anti-fraud provision, section 10(b) of the Exchange Act. In essence therefore U.S. insider trading law is judge-made and for that reason its development has not always progressed smoothly nor have its limits been clear. For example, there is no general definition of 'insider trading' itself. Neither the courts nor the SEC have attempted to define the term, the latter taking the view that such a definition would their hamper enforcement efforts.[11]

The prohibition of insider trading has been justified for two main reasons in the United States. The first is that insider trading poses a threat to investor confidence, an argument, which as we have seen, has been put forward by many academics. This ties in with the stated purpose of the 1934 Exchange Act, which was to "insure honest securities markets and thereby promote investor confidence".[12] The second reason advanced is that both the Securities Act and the Exchange Act were created to "embrace a fundamental purpose...to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*".[13] Clearly insider trading goes against any policy of disclosure and its regulation is a clear rejection of the *caveat emptor* principle.

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[10] See R. S. Karmel, "Outsider Trading on Confidential Information: a Breach in Search of a Duty", 20 Cardozo Law Review 83 (1998) for a detailed discussion of this subject and T. L. Hazen, *The Law of Securities Regulation*, (St. Paul: West Publishing Co., 1996) at 835.

[11] Although recently it has published a proposal which would offer some clarification on some aspects. See "Proposed Rule S7-31-99: Selective Disclosure and Insider Trading" http://www.sec.gov/rules/proposed/34-42259.htm. This proposal is discussed below at section 5 entitled Reform.

[12] *Supra* note 2.

[13] *Central Bank v. First Interstate Bank*, 511 U.S. 164 at 171 (1994).

B. The Regulation of Insider Trading

1. Introduction

As noted briefly, insider trading law is founded mainly on section 10(b) of the Exchange Act from which has sprung a large body of case law. However, section 16 also deals with insider trading by imposing a reporting obligation on directors and officers and also by prohibiting so-called short-sales and short-swing profits. This section is therefore discussed first.

2. Regulation under Section 16 of the Exchange Act

a) Section 16(a): the Reporting Obligation

Section 16(a) requires that directors and officers[14] of a company with an equity security registered under section 12 of the Exchange Act, and, any person who is directly or indirectly the beneficial owner of more than ten percent of any class of any registered equity security, file a report detailing their holdings. The report must be submitted to the SEC and the Exchange on which the securities are registered. Additionally, a further report must be submitted within ten days of the end of the calendar month if there has been any change in that person's holdings.[15]

The SEC may make the reports available to the public under section 24 of the Exchange Act and rule 24(b). Indeed the policy of the SEC has been to so disclose reports. There has been a notable reluctance on the part of the SEC to afford insiders' reports any confidential treatment.[16] Whilst the reports are intended to be purely for the purposes of disclosure they do also facilitate the enforcement of section 16(b).[17]

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[14] "Officer" includes at least the president, vice-president, secretary and comptroller or treasurer, and any person who holds these positions *de facto*. See E. Gaillard, ed., *Insider Trading: The Laws of Europe, the United States and Japan*, (The Hague: Kluwer Law and Taxation, 1992) at 321 note 179.
[15] Since 1996, reporting of some transactions exempt from short-swing profit recovery under section 16(b) is no longer required. See Securities Exchange Act Release 37,260, 62 SEC Dock. 138, 151-156 (1996).
[16] Discussed in B. K. Rider and H. L. Ffrench, *The Regulation of Insider Trading*, (London: Macmillan Press, 1979) at 23.
[17] See Loss *supra* note 3 at 554.

b) Section 16(b): the Short-Swing Profits Rule

This section provides that insiders may not both buy and sell their company's securities in a six month period. Insiders are defined in section 16(a) as being directors, officers and ten percent shareholders. Section 16(b) provides as follows:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase, sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall injure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.[18]

It provides for the recovery by the issuer of any profits made by the insider. An action may be brought either by the issuer or, if the issuer fails or refuses to bring suit sixty days after being requested to do so, by any owner of a security in the issuer, the latter bringing a derivative action on behalf of the issuer. With respect to beneficial owners, the section will only apply if beneficial owners have a holding of at least ten percent in the issuer at the time of both the sale and the purchase of the securities by that beneficial owner. With reference to directors and officers, the section applies beyond the time that they leave office. Section 16(d), which was added in 1964, exempts market makers from liability under section 16(b).

The section was intended to protect 'outside' shareholders against short swing speculation by 'insiders' with advance information without discouraging long-term

[18] Section 16(a) of the Exchange Act *supra* note 2.

investment made in good faith.[19] As a result, it is not necessary to show an actual unfair use of inside information. However, an insider who does make unfair use of inside information, but who waits more than the requisite six months before selling his securities, will not be caught by section 16(b). Similarly, the section is limited in scope in terms of which insiders are caught. It does not cover, for example, other employees or other persons with access to information, nor does it deal with tipping. Additionally the provision only applies to securities held in public companies.

The advantages of section 16(b) lie in the fact that it is a simple provision and does not require proof of fraudulent or manipulative behaviour. As a result it is easy to enforce: there is no need to establish scienter, materiality, causation or reliance since the insider is not required to have even been in possession of inside information. Thus, actions are likely to brought more readily and the removal of transaction profits should have a strong deterrent effect. However the section would have more force if it were accompanied by a penalty.[20]

c) Section 16(c): the Rule Against Short Selling

Section 16(c) provides that it is unlawful for a beneficial owner, director or officer[21] to sell, directly or indirectly, any equity of the issuer, if either, (1) he does not own the security sold, or (2) he owns the security but does not deliver it within twenty days, or deposit it in the mails within five days. There is no liability if, acting in good faith, delivery could not be made within the requisite time limit because to do so would cause undue inconvenience and expense.[22]

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[19] The UK's Model Code also provides that directors should not deal in their companies' securities on short-term considerations.
[20] The value of section 16(b) is discussed by Rider and Ffrench *supra* note 16 at 45-46.
[21] As defined in section 16(a) of the Exchange Act *supra* note 2.
[22] Section 16(c) of the Exchange Act *ibid.*

The purpose of the section is to prevent insiders short selling in their own securities. It prevents two kinds of transaction. First, insiders may sell shares that they do not own, borrowing them to make delivery, then buying an identical amount of shares to deliver to the lender, or purchasing to make delivery. Secondly, insiders may sell their holdings but keep the shares registered in their names, borrowing to make delivery, then buying shares to repay the lender. Thus the insider's position is not made known until delivery is made at a later date. This is known as a 'sale against the box'.[23]

3. Regulation under section 10(b)

a) Introduction

Section 10(b) is the principal provision used in insider trading cases in the United States. In fact the section was not designed to deal with insider trading and therefore makes no reference to it. Rather, it was intended to prohibit fraudulent or manipulative practices in connection with the purchase and sale of securities. However, from section 10(b) has emanated expansive case law which deals with insider trading and now regulates it tightly. Indeed, Chief Justice Rehnquist famously described insider trading law as a "judicial oak which has grown from very little more than a legislative acorn".[24] Section 10(b) was first applied to insider trading in the context of private litigation and was later used by the SEC in the 1960s as part of an aggressive enforcement strategy.[25]

Section 10 provides as follows:

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

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[23] This is explained in detail in Rider and Ffrench *supra* note 16 at 46-47.
[24] Chief Justice Rehnquist in *Blue Chip Stamps v Manor Drug Stores* 421 U.S. 723 (1975).
[25] Discussed in M. Ashe and L. Counsell, *Insider Trading*, 2nd edition, (Croydon: Tolley Publishing Company, 1993) at 29.

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national 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.[26]

The SEC subsequently adopted Rule 10b-5 to supplement the section:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[27]

b) The Duty

Liability under section 10(b) and rule 10b-5 was premised on a theory that was first developed in the late 1940s.[28] The essence of the rule that was developed by the courts is that certain persons who are knowingly in possession of material non-public information relating to a company must either disclose that information prior to entering into a transaction, or, they must abstain from trading altogether.

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[26] Section 10 of the Exchange Act *supra* note 2.
[27] SEC rule 10b-5 17 C.F.R. § 240.10b-5 (1998).
[28] It was referred to in *Baird v. Franklin*, 141 F.2d 238, 244 (2d Cir. 1944), *cert.* denied, 323 U.S. 737, and in *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

The disclose or abstain duty was firmly established in *In re Cady, Roberts & Co.*.[29] The SEC held that there was an affirmative duty on corporate insiders, particularly, officers, directors, or controlling shareholders, to disclose material facts known to them by virtue of their position which would affect the judgement of an investor. The rule was set out as follows:

> Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to affecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[30]

The aim of the disclose or abstain duty was to introduce an equalisation process into such a transaction.[31] Thus, in *Speed v. Transamerica Corp.*, it was held to be unlawful for a majority shareholder to buy shares from minority shareholders without first having disclosed material facts affecting the value of the shares. This was because those material facts were obtained by virtue of the majority shareholder's position as an insider and because those material facts would have affected the judgement of the sellers when deciding whether or not to sell their shares.[32]

The majority shareholder in that case had a duty to either disclose the facts or to abstain from trading. That duty arose from a kind of fiduciary relationship which was established between the majority shareholder and the minority shareholders.[33] By not disclosing the material facts the majority shareholder was in breach of his fiduciary duty to the minority shareholders, for which the latter could recover.

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[29] *In re Cady, Roberts & Co.* 40 SEC 907 (1961).
[30] *Ibid* at 911.
[31] *Speed v Transamerica Corp.* 99 F. Supp. 808, 828-829 (D. Del. 1951).
[32] *Ibid.*
[33] *Ibid.*

c) *Use or Possession of Material Non-Public Information?*

One question that has arisen with respect to the disclose or abstain rule is whether or not liability arises when an insider actually makes use of inside information when deciding to trade or whether liability arises when insiders simply trade whilst in fact in possession of inside information.

The position taken by the SEC in the actions it brought so far has been that trading whilst knowingly in possession of information is enough to create liability. The actual trading itself need not have been on the basis of the non-public information. The advantage of this approach is that it eliminates the problem of the courts being forced to decide what the defendant was thinking at the time of trading and permits convictions largely on the basis of what is essentially circumstantial evidence.

Indeed the most problematic element of insider trading regulation is evidence. Unless blessed with a convincing witness who discussed the trading with the insider, a prosecutor is left with very little except for a suspicious pattern of trades. Taking out an element of the *mens rea* means that convictions are easier to obtain.

However, there is of course a downside to this approach in so far as it catches innocent traders who have made plans to trade before in fact learning of the material non-public information. Such was the case in *SEC v. Baker*[34]. In that case, the SEC actually accepted that Baker had made his decision to trade before coming into possession of material non-public information, but initiated the proceedings anyway. Baker was forced to agree to disgorge his trading profits plus interest and to pay a civil penalty. On these facts it is regrettable that the SEC did not operate a more selective policy of enforcement.

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[34] *SEC v. Baker* 93 Civ. 7398 (RWS), Litigation Release No. 13850 (1993).

Nonetheless the Second Circuit lent its support for the SEC's approach in *United States v. Teicher*[35]. In the dicta of *Teicher*, the court indicated that if faced with the question it would support the SEC and would adopt the "knowingly in possession" standard.

In 1998 however, two Courts of Appeal criticised the SEC's position and rejected the *Teicher*[36] dicta. In *SEC v. Adler*[37], the Eleventh Circuit held that in civil enforcement proceedings, the SEC could rely on a 'strong inference' that a person who trades whilst in possession of material non-public information actually used that information when deciding whether or not to buy or sell. However, the trader could then rebut the inference by adducing evidence that the information was not in fact used. In *U.S. v. Smith*[38], the Ninth Circuit rejected outright the contention that in a criminal prosecution the Government could rely on such an inference to establish that the defendant had used information. Thus, in both cases the Courts decided that the use of inside information rather than mere possession was required for liability.

The *Adler*[39] court also suggested that rule 10b-5 was inadequate and recommended that it be amended or a new rule adopted which would clarify the issue:

> We note that if experience shows that this approach unduly frustrates the SEC's enforcement efforts, the SEC could promulgate a rule adopting the knowing possession standard, as the SEC has done in the context of tender offers … or a rule adopting a presumption approach in which proof that an insider traded while in possession of material non-public information would shift the burden of persuasion on the use issue of the insider.[40]

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[35] *United States v. Teicher* 987 F.2d 112 (2d Cir.), cert. denied, 114 S.Ct. 467 (1993).
[36] *Ibid.*
[37] *SEC v. Adler* 137 F.2d 1325, 1337-39 (11th Cir. 1998).
[38] *United States v. Smith* 155 F2d 1051, 1066-69 (9th Cir. 1998).
[39] *Supra* note 37.
[40] *Ibid* at 1337 n.33.

Following their defeat in this case and in *Smith*[41] the SEC took the advice of the Court and has recently proposed a new rule.[42] Unsurprisingly, the SEC opted for a rule which allows for liability when a person simply trades whilst in possession of information:

> In our view, the goals of insider trading prohibitions – protecting investors and the integrity of securities markets – are best accomplished by a standard closer to the "knowing possession" standard. Whenever a person purchases or sells a security while aware of material non-public information that has been improperly obtained, that person has the type of unfair informational advantage over other participants in the market that insider trading law is designed to prevent. As a practical matter, in most situations it is highly doubtful that a person who knows inside information relevant to the value of a security can completely disregard that knowledge when making the decision to purchase or sell that security. In the words of the Second Circuit, "material information can not lay idle in the human brain." Indeed, even if the trader could put forth purported reasons for trading other than awareness of the insider information, other traders in the market place would clearly perceive him or her to possess an unfair advantage.

It is interesting that the SEC comments on the perception of unfairness by other traders. This fits with the aim of SEC to maintain investor confidence in the markets. It is not an acceptable reason for prosecuting 'innocent' traders as in *Teicher*[43] however.

Ultimately though, whilst it rejected the "strong inference" approach which had been suggested by the *Adler*[44] court, the SEC has taken a fairly moderate view since it offers four defences. Under proposed Rule 10b5-1 it would be illegal to trade on the basis of material non-public information if a trader "was aware of" the information when he made the purchase or sale.[45] The four defences are set out in paragraph (c). First, an affirmative

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[41] *Supra* note 38.
[42] Proposed Rule S7-31-99 *supra* note 11.
[43] *Supra* note 35.
[44] *Supra* note 37.
[45] See proposed rule 10b5-1 paragraphs (a) and (b) in Proposed Rule S7-31-99 *supra* note 11.

defence is available if, before becoming aware of material non-public information, a person had entered into a binding contract to trade in the amount, at the price and on the date on which he ultimately traded. Secondly, a defence is available if the trader can show that prior to obtaining the information he had instructed another person to carry out a trade on his account in the amount, at the price, and on the date on which the trade was ultimately executed. Third, there is a defence if the trader can show that the trades were part of a pre-established program of buying or selling those particular securities. This defence requires a written plan of the proposed trades. Fourth, there is a defence if the trader can show that his trades merely corresponded with a written plan for trading which tracks a market index.[46]

The Proposed Rule would indeed clarify this element of insider trading liability. If adopted, traders would at least know that they should keep written records of intended share trades. Particularly helpful would be the defence whereby a trader can show he had instructed his broker before obtaining the information. The Proposed Rule does not make provision for a situation in which a trader may be forced to sell his securities for reasons of serious financial difficulty. This is unfortunate but it was perhaps thought that such a defence would be abused.

d) Who is an Insider?

There has been much debate about who in fact qualifies as an insider for the purposes of section 10(b) and rule 10b-5. There are two main schools of thought. The first may be described as the 'classical theory'.[47] This theory essentially limits liability to 'corporate insiders' such as directors, officers and substantial shareholders of a company and also to some other 'temporary insiders' such as lawyers and accountants. The second theory catches anyone who becomes privy to, and trades on the basis of, material non-public

[46] See proposed rule 10b5-1 paragraph (c) in Proposed Rule S7-31-99 *supra* note 11.
[47] This was the terminology used by the Supreme Court in *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

information but who owes no fiduciary obligation to the company or its shareholders. This broader theory is known as the 'misappropriation theory' and until recently the courts were divided in their acceptance of it. The conflict was resolved recently when the Supreme Court finally approved the misappropriation theory in *United States v. O'Hagan*.[48]

(1) The Classical Theory

The classical theory imposed the duty to disclose or abstain only on 'classic' insiders such as directors and officers. These are the classic insiders as defined in section 16 of the Exchange Act. Some 'outsiders' are also required to comply with the rule by virtue of a relationship held with a company. Such outsiders are those persons who are otherwise independent but who could be viewed as 'insiders' in situations in which they are rendering professional services to a company. These persons have become known as 'temporary insiders', and include lawyers, accountants, financial advisors, underwriters and other consultants to a company.

The essence of the classical theory is that insiders are those persons who are in a relationship with a company and thereby obtain inside information. These persons are either fiduciaries or have a fiduciary-like relationship with the company. Because of that fiduciary or fiduciary-like relationship such persons are bound by an obligation to disclose any material non-public information that they may hold when trading in the securities of that company.[49] This affirmative duty renders silence fraudulent and therefore in breach of section 10(b) and rule 10b-5.

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[48] *Ibid.*
[49] *Supra* note 29.

In *In re Cady, Roberts & Co*[50] the court set out a test to describe the duty which incorporated an unfairness element. This was that where one party had a special relationship with a company and that party took advantage of inside information knowing that it was not available to the party on the other side of the transaction, there would be an inherent unfairness. These unfair transactions were prohibited. A party in the special relationship with the company has a duty to disclose the inside information or abstain from trading.[51]

The duty owed by corporate insiders to disclose or abstain was acknowledged by the Supreme Court in *Chiarella v. United States*[52] when the Court affirmed that trading by such persons on the basis of inside information qualified as a "deceptive device" for the purposes of section 10(b) because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation"[53]. The Supreme Court further added that such a relationship gave rise to a duty to disclose or abstain because of the "necessity of preventing a corporate insider from ... tak[ing] unfair advantage of ... uninformed ...stockholders".[54]

In *Dirks v. SEC*[55] the Supreme Court clarified the scope of the 'temporary insider' classification, creating a two pronged test: persons may be treated as insiders for the purposes of insider trading laws where (1) a special confidential relationship exists pursuant to which that person has access to information which is being provided to him for corporate purposes and (2) where there is and expectation (implicit or explicit) that the information will be kept confidential.[56] The Supreme Court reasoned that by virtue of

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[50] *Ibid.*
[51] *Ibid* at 912.
[52] *Chiarella v. United States*, 445 U.S. 222 (1980).
[53] *Ibid* at 228.
[54] *Ibid* at 228-229.
[55] *Dirks v. SEC*, 463 U.S. 646 (1983).
[56] *Ibid.*

the special confidential relationship with the company such temporary insiders became fiduciaries of the shareholders:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired non-public corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to the information solely for corporate purposes... For such duty to be imposed, however, the corporation must expect the outsider to keep the disclosed non-public information confidential, and the relationship at least must imply such a duty.[57]

The scope of 'temporary insider' was therefore defined narrowly and did not include persons who obtained inside information otherwise than for corporate purposes. The expectation of confidentiality was also an important limitation. A similar limitation was incorporated in the 1985 United Kingdom statute[58] relating to insider trading but was abandoned in favour of a simpler provision in 1993[59].

(2) The Misappropriation Theory

Limiting insider trading liability to traditional and temporary insiders meant that there remained situations in which persons owing no fiduciary obligation to the company or its shareholders nonetheless became privy to, and traded upon, inside information. The SEC therefore offered an alternative basis for liability that became known as the misappropriation theory. Under this theory, a person violates insider trading law if he misappropriates material non-public information for securities trading purposes, in breach of a fiduciary or similar duty owed to the source of the information. Liability can

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[57] *Ibid* at 655.
[58] *Company Securities (Insider Dealing) Act 1985*, (U.K.) 1985.
[59] *Criminal Justice Act 1993*, (U.K.) 1993, Part V.

therefore attach even though the source of the information is unaffiliated with the buyer, seller or issuer of the securities in question.

The SEC submitted the theory to the courts for the first time in *Chiarella v. United States*[60]. Chiarella was a mark up man at a printing firm who had been who had been working on tender and merger documents. From the documents, he was able to deduce the identity of the target companies, whose names had been concealed. He subsequently traded in the target companies' securities and amassed a large profit. He was charged under section 10(b) and rule 10b-5.

The SEC argued that Chiarella was liable because he had breached a duty which he owed to his employer and to his employer's clients (the predator companies) even though he owed no duty to the persons with whom he traded. Whilst the majority of the court did not accept this argument, in his dissent, Chief Justice Burger asserted that a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading.[61]

Following Chiarella[62], the Secondly Circuit not only stood firmly in favour of the misappropriation theory[63] but it developed it further. In *United States v. Carpenter*[64] a financial journalist was charged with informing a firm of stockbrokers of the content of his column prior to its publication. Since the journalist's views were considered valuable, the column often affected the price of securities discussed in it. The firm therefore traded on the securities mentioned in the column ahead of the public and the defendant was convicted.

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[60] *Supra* note 52.
[61] *Ibid* at 240.
[62] *Ibid.*
[63] See *SEC v. Materia*, 745 F.2d 197 (2d Cir, 1984).
[64] *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), aff'g in part and rev'g in part *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), aff'd in relevant part by an equally divided Court, 484 U.S. 19 (1987).

The case was controversial because it did not involve inside information and the defendant was not an insider. In fact, the contents of the column were merely the product of the defendant's own analytic efforts and did not contain any material non-public information in the usual sense. The journalist did not have any special relationship with the issuers and therefore was not an insider. However, the publication for which he worked, the Wall Street Journal, did have an internal policy which deemed that all material produced by employees during their employment belonged to the Journal. Given this, the SEC were able to argue successfully that the journalist had misappropriated his employer's property and thus the conviction was supported. Of course under this theory, the Wall Street Journal would still have been able to legally trade on the contents of the article, being the owner of the information.[65]

The wide scope of the misappropriation theory unsurprisingly meant that it was heavily criticised and the federal court of appeals became divided in their acceptance of it. The Secondly Circuit applied the theory from the outset but the Fourth Circuit however was quick to reject it in United States v. Bryan.[66] That court found that neither the text of section 10(b) nor of rule 10b-5 could support a conviction based upon the misappropriation theory.

The debate was resolved by the Supreme Court in United States v. O'Hagan.[67] This case involved 'classic' insider trading. O'Hagan was a partner in a law firm who obtained information about a client that was in the process of was submitting a tender offer for another company. O'Hagan traded in the target company's shares and made a profit of more than US$4.3 million. The trial jury convicted him, but his conviction was overturned by the Eighth Circuit court of appeal.

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[65] See discussion in D.M. Brodsky and D.J. Kramer, " A Critique of the Misappropriation Theory of Insider Trading" (1998) 20 Cardozo Law Review 41 at 67.
[66] *United States v. Bryan* 58 F.3d 933 (4th Cir. 1995).

The Supreme Court, however, reinstated the conviction. They discussed both classical insider trading theory that holds corporate and 'temporary' insiders liable, and the misappropriation theory. The Court held that the two theories were complementary. The misappropriation theory they found was justified on the basis of its deceptive element: a misappropriator who trades on the basis of material non-public information gains his advantageous market position through deception. He deceives the source of the information and simultaneously causes harm to other investors. This, the Court argued, was the type of conduct that the Exchange Act had been intended to deal with, since its purpose was in part to ensure the maintenance of honest and fair markets. The Court further supported its argument by reference to the theory that insider trading damages investor confidence in the markets.[68]

The Supreme Court decision has been heavily criticised predominately because it contributed little in the way of much-needed clarity in U.S. insider trading law. Whilst it confirmed the validity of the misappropriation theory, the scope of this theory remains unclear.[69] This is because the fiduciary-like relationships which fall within the theory are not defined and thus vary from state to state. Humke describes the problem as follows:

> ...the theory has imposed liability arising from such diverse associations as between an employer and current employee, an employer and former employee, a newspaper and columnist, a psychiatrist and patient, a husband and wife, and a father and son. Whether a fiduciary or similar relationship of trust and confidence existed in each case depended of the law of the state where the breach occurred. As such the misappropriation theory, in effect, assumes fifty

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[67] *Supra* note 47.
[68] *Ibid* at 2210.
[69] See A. Alcock, "Misappropriation Restored" (1997) Journal of Business Law November Issue at 562.

> very different permutations, with some permitting certain trading practices where others prohibit them, and vice versa.[70]

The result is that investors cannot be sure when they are breaching the law, and according to Humke, the problem with providing clear guidelines would be to take away from states an important element of their rule-making power which contradicts federalism:

> The misappropriation theory, with its foundations grounded in breaches of state-governed relationships, simply does not provide clear guidelines by which investors may order their affairs, a problem whose obvious solution contradicts fundamental principles of federalism.[71]

Humke notes that whilst a "federalized set of fiduciary relationships" would obviate the shortcomings of the misappropriation theory such an approach would be "impracticable and tantamount to an usurpation of state authority".[72] Bainbridge argues that the principles of federalism should not be sacrificed in order to clarify insider trading:

> Granted, reliance on state law will complicate insider trading prosecutions. But no more so than any other case where state standards are incorporated into federal common law. In any case, there are affirmative reasons to adopt state law as the rule of decision. By acknowledging that insider trading is primarily a matter for state law, like all other questions of fiduciary duty, this approach accords proper deference to the states' position as the primary regulator of corporate governance questions.[73]

However, whether it is down to federal or state regulators to provide a definition, the clear message from most commentators is that any such uncertainty is undesirable. In O'Hagan the Supreme Court was given an opportunity to rework insider trading theory

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[70] J.J. Humke, " The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)" (1997) 80 Marquette Law Review 819 at 844-5.
[71] *Ibid* at 844.
[72] *Ibid* at 845-6.
[73] S.M. Bainbridge, "Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition" (1995) 52 Washington and Lee Law Review 1189 at 1269.

and to set some clear boundaries. Rather than do this, it opened the door wider and thus added to the confusion. Swanson criticised the decision as follows:

> The landmark decision reinvents insider trading law by approving a fraud on the source misappropriation theory with too little content and too many questions. Far from resolving long-standing insider trading debates, ...the Court's decision represents a valuable opportunity lost, leaving important old questions unanswered, creating troublesome new issues for future consideration, and advancing policy rationales not consistent with the holding.[74]

Thus the O'Hagan decision by the Supreme Court was not particularly helpful in developing U.S. insider trading law. The continuing lack of a clear definition of insider trading represents a threat to fairness and to investors, whose ability to assess when they are 'insiders' will still be largely the result of educated guesswork. This, in the words of Brodsky and Kramer, raises a "significant constitutional concern" namely that "due process requires people to be fairly apprised whether certain actions are illegal".[75] The underlying principle of due process is that "no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed".[76] To violate due process is to violate a basic human right. To put federalism before due process seems to be unjustified, particularly since in the United States, as will be seen later, the sanctions for insider trading are by no means light.

e) Tippers and Tippees

Insider trading liability also attaches to outsiders who are "tipped" inside information by persons having access to that information. Both "tippers", persons who pass inside information to others, and "tippees", the recipients of inside information, risk sanctions.

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[74] C.B. Swanson, "Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory" (1997) 32 Wake Forest Law Review 1157 at 1160.
[75] *Supra* note 65 at 80.
[76] *United States v. Harris*, 347 U.S. 612, 617 (1954).

(1) Tipper Liability

A person who passes on material non-public information may be in breach of Rule 10b-5 even if he does not trade on the inside information himself. A person is liable when he improperly makes inside information available to another person, in violation of a fiduciary or similar duty, and that other person then trades. The Supreme Court has indicated that liability will depend on the purpose of the insider's disclosure. If the disclosure is made for the tipper's direct or indirect personal benefit then the tipper is liable.

A personal benefit for these purposes need not be cash or the avoidance of a loss, but can be a "reputational benefit" that could translate into future earnings. Thus, in SEC v. Stevens[77] the SEC alleged that a corporate officer who contacted an investment analyst in the hope that the analyst would say favourable things about him would be misusing corporate information for personal gain. Information passed by way of a gift to another person is also classed as a personal benefit.[78]

(2) Tippee Liability

A tippee is subject to the duty to disclose or abstain from trading when he has received inside information from an insider and he is aware that the tipper is breaching the duty. Thus if the tippee is knowingly in possession of material non-public information which (1) a tipper has improperly passed to the tippee in breach of a fiduciary or similar duty, and (2) the tippee knows or should have known that the information was passed in violation of a duty, he should not trade on that information. [79]

The tippee is therefore subject to a derivative of the disclose or abstain duty. This means that in theory if a tippee goes on to tip another person, and that person knows or

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[77] *SEC v. Stevens*, 23 Sec. Reg. & L. Rep. (BNA) 439 (S.D.N.Y 1991).
[78] *Supra* note 55 at 646 and 664
[79] Illustrated in the "Merrill Lynch trilogy": *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 633 (1968); *In re Investors Management Co.*, 44 SEC (1971); *Shapiro v. Merrill Lynch Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

reasonably should know that the tipped information originated from an insider who was in breach of his duty, the 'sub-tippee' could also be found to be liable.

f) Inside Information

As discussed, inside information in the United States is defined as "material non-public information". The elements of this definition will now be considered.

(1) Materiality

Information is material if there is a substantial likelihood that the disclosure of the information would be viewed by the investor as having significantly altered the total mix of the information made available[80] although the Supreme Court has not defined materiality specifically in the context of insider trading.

However, information can be considered to be material even if it suggests only a limited probability of a certain event occurring. For example in SEC v. Texas Gulf Sulphur Co.[81] the information concerned was a favourable drilling report in relation to a mining field. The first instance court found that the information was too remote to have any significant impact on the company's securities, whereas the appeals court considered that the information would have been important to a reasonable investor. The appellate court's findings have to be correct in this case. A defendant who claims that information is insignificant but who has bought large quantities of securities immediately on learning the information himself, is implausible.

(2) Non-Public Information

Information is non-public until the markets have had time to fully 'digest' the information. There are two main views as to the meaning of this. First, some courts have taken the view that the number of persons to whom the information has been disclosed is irrelevant. Rather, the information must have been absorbed into the market price of the securities to no longer be 'non-public'.[82]

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[80] *TSC Industries Inc. v.. Northway*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).
[81] *SEC v Texas Gulf Sulphur Company*, 401 F.2d 833 (2d Cir. 1968).
[82] See for example *United States v. Liberia*, 989 F.2d 596, 601 (2d Cir. 1993).

The other view, which is the view held by the SEC, is that the information must have been disclosed "by a public release through the appropriate public medium" in order to become "public".[83] On the face of it, this theory seems to be fairer. It is clearly easier for a trader to determine when information has been disclosed to the public than to calculate when the market price of a security has stabilised. Moreover, it seems unfair to deny the insider the right to trade in securities on the basis of information which is now public. However, the SEC has taken the definition to an extreme. In one case, an insider was liable for trading on the basis of information that had been disclosed in a press release two weeks earlier because the SEC considered that the appropriate public medium was the Wall Street Journal article in which the information later appeared.[84] This seems unfair because to define public disclosure would be straightforward and would result in much greater clarity and fairness to traders.

g) Scienter

As a prosecution for insider trading amounts to a prosecution for fraud under U.S. law, scienter is an element of the offence. The requisite scienter is an intent to defraud. Whilst no court has addressed scienter specifically in relation to insider trading, the standard appears to be trading or tipping whilst knowingly in possession of information.[85]

4. Regulation under section 14(e) of the Exchange Act

The SEC adopted rule 14e-3 under section 14(e) of the Exchange Act. The rule addresses insider trading in the context of a tender offer and applies whenever any person has taken a substantial step or steps to commence, or has commenced, a tender offer, and another person is in possession of material information relating to that tender offer. That person must know or have reason to know that the material information is non-public. The information must have been obtained directly or indirectly from the offeror or from the

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[83] *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973).
[84] *SEC v. MacDonald*, 586 F. Supp. 111 (D.R.I. 1983), aff'd, 725 F.2d 9 (1st Cir.. 1984).
[85] For example, Teicher *supra* note 35 at 120-121.

target company, or from any director, officer, partner, employee or other person acting for the offeror or the target.

Rule 14e-3 liability is incurred if the person with such information buys or sells, or causes to be bought or sold, any of the target company's securities or options unless the information and its source have been publicly disclosed within a reasonable time before the trade. Its scope is more restrictive than rule 10b-5 but it is considerably easier to prove as there is no need to show that a fiduciary or similar relationship existed or was breached.

Rule 14e-3 provides a defence for multi-service financial institutions and other legal persons, when the individual making the relevant investment decision did not know about the impending tender offer, and the institution had effected a Chinese wall.[86]

In O'Hagan the Court of Appeal found that the SEC had exceeded its rulemaking authority under section 14(e) when it adopted rule 14e-3.[87] However, the Supreme Court disagreed and thus reinforced the authority of the rule.[88] Morrissey argues that in accepting the rule the Supreme Court was more influenced by policy and "egregious" facts than by law:

> Looking to the egregious facts of this case and the policy concerns underlying the securities laws, the court thought this extension would provide an effective tool for extending liability in insider trading cases.
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> While this case is "fair" from a policy standpoint, it is not sound from a legal standpoint. In both instances, the Court was guided by policy considerations

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[86] See Loss *supra* note 3 at 866.
[87] The O'Hagan appellate court *supra* note 47.
[88] The Supreme Court in O'Hagan *supra* note 47.

aimed at attaining fairness in this particular case rather that following the precedent established in previous insider trading cases.[89]

However, to have reached a contrary decision in O'Hagan on the facts before the court would have been ridiculous, since there can hardly be a clearer case of wrongful insider trading. The situation envisaged by rule 14e-3 is classic insider trading as tender offers provide one of the surest and most lucrative ways of profiting from insider information. Thus the rule is indeed fair from a policy standpoint and at least provides certainty in this very uncertain area of U.S. law.

5. Sanctions

(1) Civil penalties available to the SEC

Originally the SEC was restricted to seeking only disgorgement of profits from insider traders before the civil courts. However, in 1984, the Insider Trading Sanctions Act (ITSA) was passed. This broadened the SEC's remedies, allowing a court to impose a fine of up to three times the profit made, or loss avoided, by the insider trader, in an action brought by the SEC for violation of a provision or rule under the Exchange Act prohibiting insider trading.[90]

This penalty is available in addition to disgorgement, so, effectively four times the profit made can be recovered. Furthermore, the money obtained may be used to pay an informant. The provision can be used against insider traders (insiders and tippees) and also tippers.

A further sanction was added by the Insider Trading and Securities Fraud Enforcement Act 1988.[91] This allows the SEC to fine firms employing insider traders who do not adequately supervise employees or adopt sufficient Chinese wall type procedures. A

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[89] J.W. Morrissey, "United States v. O'Hagan: A Results-Oriented Approach to Insider Trading Cases" (1998) 48 DePaul Law Review 161 at 196.
[90] This is now section 21A of the Exchange Act *supra* note 2. It was added by the *Insider Trading Sanctions Act of 1984*, Pub. L. No. 98-376, 98 Stat. 1294 [hereinafter ITSA].
[91] The new section 21A of the Exchange Act, *supra* note 2, was amended.

penalty of up to U.S.$1,000,000 or three times the profit made by the trader may be imposed.

It is worth noting that the SEC can also impose administrative sanctions. It has the power to suspend or revoke the licence of a registered security professional. It may also impose fines in administrative proceedings.

(2) Criminal Sanctions

The SEC cannot bring criminal proceedings itself. Instead the Justice Department must bring any action, and the SEC's role is essentially a co-operative one.

Criminal sanctions were originally brought under section 32(a) of the Exchange Act which criminalises the wilful violations of the federal securities laws. However, the maximum penalty was thought to be insufficient, therefore prosecutions were sought under alternative statutes. Usually the Mail and Wire Fraud statutes were employed. These offered higher penalties (five years imprisonment or U.S.$1,000 fine for each count) and the defendants could be charged on several counts.[92] Additionally, prosecutions have been brought under RICO (the Racketeer Influenced and Corrupt Organizations Act 1970) which was designed to combat organised crime.

However, the above statutes were not intended to be used to sanction insider trading, so for this reason Congress made proper provision in ITSA[93] and ITSFEA[94] as discussed earlier. Thus under the amended section 32(a) of the Exchange Act an offender risks imprisonment for up to ten years and/or a penalty of up to U.S.$1,000,000 for individuals. A penalty of up to U.S.$2,500,000 may be imposed on contravening institutions.

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[92] See E. Gaillard *supra* note 14 at 310-311.
[93] ITSA *supra* note 90.

(3) Private remedies

It was well established in case law that a private right of action was available under rule 10b-5 and rule 14e-3 for those to whom the insider trader owed a fiduciary duty. However, the misappropriation theory was originally held to be unavailable to private plaintiffs bringing suit against persons who traded while in possession of misappropriated information. United States Congress considered this to be unfair provided for recovery in ITSFEA, which created section 20A of the Exchange Act. Section 20A creates a remedy for a private plaintiff who loses money while trading contemporaneously with a person who has violated the Exchange Act by trading while in possession of material non-public information. Thus anyone who trades in securities on the opposite side of the transaction contemporaneously with the insider trader may recover the loss avoided or profit made by the latter.

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[94] *The Insider Trading and Securities Fraud Enforcement Act of* 1988, Pub. L. No. 100-704, 102 Stat. 4677 [hereinafter ITSFEA].

CHAPTER THREE: INSIDER TRADING IN CANADA

I. THE REGULATORY SYSTEM

A. Overview

Statutory regulation of securities in Canada has predominantly been a matter left to the provinces although since the 1960s strong arguments have been put forward in favour of the adoption of a federal securities statute. Currently however, each of the provinces and territories has its own securities regulation. This comprises securities acts, regulations and national policy statements as well as administrative and case law.[1]

Some federal legislation is relevant to the regulation of securities however, notably the Canada Business Corporations Act (CBCA)[2] which regulates the conduct of federally incorporated companies and also the Canada Criminal Code (CCC)[3] which contains some provisions relating to securities such as the sections regulating fraud, misrepresentation and market manipulation.

The various forms of securities regulation are enforced by administrative agencies located in each jurisdiction. In the provinces in which the majority of the country's securities activity occurs (what Johnston calls the "major securities provinces"[4]), these agencies function at a two-tier level. The structure of these administrative bodies is largely the same. The Ontario Securities Commission is discussed below.

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[1] See D. Johnston and K.D. Rockwell, *Canadian Securities Regulation* (Toronto: Butterworths, 1998) at 7-8.
[2] *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (as amended).
[3] *Criminal Code*, R.S.C. 1985, c. C-46 (as amended).
[4] These are Alberta, British Colombia, Manitoba, Newfoundland, Nova Scotia, Ontario, Quebec, and Saskatchewan. See Johnston *supra* note 1 at 7.

The drawbacks of this fragmented system are obvious. It is often necessary to deal with several agencies and to comply with the regulations of several provinces. Resources are wasted due to high compliance costs and time consuming cumbersome procedures. For example, a selling issuer may have to meet the initial and continuous disclosure requirements of up to 12 jurisdictions. Additionally, a federally incorporated entity must meet the requirements of the CBCA. Whilst there have been some advances in terms of increased co-ordination between the provinces, the fact remains that these efforts have not been adequate to attract both domestic and foreign market participants.[5]

The problem is compounded by the fact that in each jurisdiction there are self-regulatory organisations whose rules also must be complied with. These include the stock exchanges[6] and various financial services associations. Therefore increasingly there have been calls for the creation of a national regulator.

Johnston sets out some assumptions, however, which he considers to be common to all Canadian securities regulation. These are as follows. First, regulation should not impose excessive cost or intervention. Secondly, investors and issuers cannot escape some level of risk, ranging from minimal to severe. Third, experience demonstrates a proven correlation between risk and return.[7]

If this is so, the philosophy behind Canadian securities regulation is one which accepts risk and generally discourages intervention. This approach differs significantly from that of regulators in the United States and the United Kingdom. In those countries, a more protective, intrusive approach is taken. The differing philosophies are evident in the general attitude towards insider trading which, although prohibited in theory, is generally

[5] See Johnston *supra* note 1 at 246.
[6] There are stock exchanges in Toronto, Montreal, Vancouver, Alberta and Winnipeg.
[7] See Johnston *supra* note 1 at 1-2.

not considered to be as harmful as U.S. and U.K. regulators would have us believe.[8] The philosophy is also reflected in the attitude of the Canadian courts to insider trading cases which will discussed later.

B. The Ontario Securities Commission[9]

1. Objectives

Created in 1937, the Commission is an independent body, not a branch of the government, as is the case with other Canadian administrative bodies that follow the British, rather than the American, model. The importance of its independence was emphasised in the Kimber Report[10]. Consequently, the Commission is separate and independent from the departmental chain of command. Its objectives are set out in the Ontario Securities Act at section 2(1):

> In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles:
>
> 1. Balancing the importance to be given to each of the purposes of this Act may be required in specific cases.
>
> 2. The primary means for achieving the purposes of this Act are,
>
> i. requirements for timely, accurate and efficient disclosure of information,
>
> ii. restrictions on fraudulent and unfair market practices and procedures, and
>
> iii. requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.[11]

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[8] See for example B. Welling, *Corporate Law in Canada – The Governing Principles* (Toronto: Butterworths, 1991) at 360-361.
[9] See generally Johnston *supra* note 1 at Chapter Four.
[10] *Report of the Attorney General's Committee on Securities Regulation in Ontario* (Toronto: the Queen's Printer, 1965) [Kimber Report].
[11] Ontario *Securities Act*, R.S.O. 1990, c. S.5 (as amended) s. 2.1(1) and (2) [hereinafter OSA.]

Thus enforcement of insider trading regulation falls well within the defined purposes of the OSC, since it must aim to 'restrict fraudulent and unfair practices' and 'maintain high standards of fitness and business conduct'.

2. *Structure*

Although the administrative structure of the securities commissions varies from province to province, the OSC has a fairly typical two-tiered system. The top tier of the Commission comprises a tribunal, a chair, and eight to ten commissioners[12] who are appointed by the cabinet of the provincial government[13]. The panel of commissioners makes orders and rulings, formulates policies and proposes changes in legislation to the provincial government. It also acts as an appellate body, hearing appeals against decisions made by the lower tier staff and SROs. The lower tier is concerned with the day to day running of the agency. It is made up of a large staff (about 250) and is headed by a chief administrative officer.

3. *Rule-making Powers*

The OSC's rule-making powers were challenged in the case of *Ainsley Financial Corp. v. Ontario (Securities Commission)*[14]. Before this case, the OSC had issued policy statements which the Court found went beyond its statutory authority. The Court held that such policy statements amounted to *de facto* laws disguised as guidelines.[15] As a result the Ontario legislature gave the OSC specific rule-making powers which are subject to ministerial approval.[16] The OSC can now issue National Instruments instead of National Policies which were general principled guidelines. Now the National Policies set out the principles relating to the exercise of discretion by the Commission.

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[12] OSA *ibid*, s. 2(2).
[13] The Lieutenant Governor in Council.
[14] *Ainsley Financial Corp. v. Ontario (Securities Commission* (1994), 121 D.L.R. (4th) 79, 21 O.R. (3rd) 104 (Ont. C.A.) (*Ainsley* cited to D.L.R.); affirming (1993), 106 D.L.R. (4th) 507, 14 O.R. (3d) 280 (ont. Gen. Div.).
[15] *Ibid* at 84.
[16] OSA *supra* note 11, ss. 143(1) and 143.1.

4. *Supervisory Responsibilities*

The OSC is responsible for the administration of the *Securities Act*[17], the *Commodity Futures Act*[18], the *Deposits Regulation Act*[19] and parts of the *Business Corporations Act*[20]. In order to achieve its supervision goals it is vested with certain powers of enforcement. The OSC undertakes investigations which usually follow complaints received. The investigations are conducted in two stages. The first stage amounts to a preliminary investigation during which the Commission gathers information relying upon the voluntary co-operation of the parties involved as it does not have the power to compel testimony.

The second stage is a formal investigation and may be commenced at the broad discretion of either the OSC or the Minister of Finance, as long such investigation is considered to be necessary in order to achieve due administration of securities law or to regulate the capital markets.[21] The investigation is commenced by an order.[22] An investigator has wide powers of investigation relating to the financial affairs of the parties.[23] He also has the power to compel the testimony and attendance of any person, the production and or inspection of documents, and even has a power of search and seizure (although not of a person's residence).[24] The powers are weakened by the fact that compelled testimony may not be used against parties in subsequent offence proceedings.[25]

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[17] OSA *supra* note 11.
[18] *Commodity Futures Act*, R.S.O. 1990, c. C.20 (as amended).
[19] *Deposits Regulation Act*, R.S.O. 1990, c. D.8 (as amended).
[20] *Business Corporations Act*, R.S.O. 1990, c. B.16 (as amended).
[21] OSA, *supra* note 11, s. 11(1)(a) and (b).
[22] OSA, *supra* note 11, s. 11(2).
[23] OSA, *supra* note 11, s. 11(3).
[24] OSA, *supra* note 11, s. 13.
[25] OSA, *supra* note 11, s. 13(3).

II. THE REGULATION OF INSIDER TRADING IN CANADA

A. The Regulation Of Securities In Canada

Historically, Canadian securities regulation was modelled on that of the United Kingdom. More recently however, the United States has had a greater influence. This trend began when Canada adopted its own "blue sky" laws. The early provincial securities statutes were similar to the American Blue Sky laws as they were primarily concerned with the prevention of fraud in the issue of securities. In 1928, Ontario introduced the *Security Frauds Prevention Act*[26] which served as a model for other jurisdictions[27]. Following the stock market crash of 1929, a uniform *Security Frauds Prevention Act* was adopted by Alberta, British Colombia, Manitoba, Ontario, Quebec, and Saskatchewan.

The first expansive securities legislation however came in 1945 with the Ontario *Securities Act*[28]. This Act notably also created a Securities Commission which was given substantial regulatory powers. Over the next few years Saskatchewan, Alberta, New Brunswick, Quebec and British Colombia enacted similar statutes.[29] This achieved a greater degree of uniformity than before.

Securities regulation in Canada was to undergo more significant reform however. In 1966 the Ontario government published the *Kimber Report*[30] which resulted in the enactment of the 1967 *Securities Act*[31] in Ontario and which was later copied by other provinces.

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[26] *Security Frauds Prevention Act*, S.O. 1928, c. 34.
[27] Alberta, Prince Edward Island, and Saskatchewan all followed suit.
[28] *Securities Act*, S.O. 1945 c. 22.
[29] *Securities Act, 1954*, S.S. 1954, c. 89; *Securities Act, 1955*, S.A. 1955, c. 64; *Securities Fraud Prevention Act (Amended)*, S.N.B. 1955, c. 73; *Securities Act (Amendment)*, S.Q. 1955-56, c. 29; and *Securities Act, 1962*, S.B.C. 1962, c. 55.
[30] Kimber Report *supra* note 10.
[31] *Securities Act*, S.O. 1966, c. 142.

In 1978, Ontario initiated a "closed system" approach.[32] This is a system under which securities cannot be traded without a prospectus unless they are subject to an exemption.[33] Over the next few years all of the "major securities provinces" adopted closed systems with the exception of Manitoba.

B. The Regulation of Insider Trading in Canada

1. Common Law Liability for Insider Trading

As had been noted, the common law of Canada was broadly the same as that of England, though some Canadian cases arguably went further to establish a remedy for insider trading.

Following the decision in *Percival v. Wright*[34] which has been discussed in Chapter One above, the general view was that directors owed no fiduciary duty to selling shareholders in the absence of very special circumstances. However, it has been argued that the common law in Canada recognised a "special facts doctrine"[35] based on the Advice of the Privy Council in *Allan v. Hyatt*[36] on appeal from the Ontario Court of Appeal. However, the special facts doctrine has since only been referred to in Obiter Dicta.[37]

In a Manitoba case though, *Gadsden v. Bennetto*[38], it was held by the Court of Appeal that directors acquiring shares after they had secretly agreed to sell the company's sole asset owed a duty of disclosure to the selling shareholders. The importance of the case was diminished by the fact that two of the judges thought that the directors were acting

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[32] *Securities Act, 1978*, S.O. 1978, c. 47; later R.S.O. 1980, c. 466.
[33] See Johnston *supra* note 1 at 112.
[34] *Percival v. Wright* (1902) 2 Ch. 421.
[35] See B.A. Rider and H.L. Ffrench, *The Regulation of Insider Trading*, (London: The Macmillan Press, 1979) at 117.
[36] *Allan v. Hyatt* (1914) 30 TLR 444 and (1914) 17 D.L.R. 7 (P.C.).
[37] For example, *R v. Littler* (1972) 41 D.L.R (3d) 523 (Quebec Ct. of Sessions of the Peace) affirmed (1974) 65 D.L.R. (3d) 443.
[38] *Gadsden v. Bennetto* (1913) 9 D.L.R. 719.

on behalf of the shareholders as well as the company and therefore owed a special duty to them.

In terms of liability to the issuer, Canadian authorities follow the English common law in that a fiduciary must not derive secret profits or place himself in a position in which he has a conflict of interest. Thus the common law is effective in establishing a duty owed by directors to the company not to abuse their position by using confidential information for their own profit.[39] It also restricts the activities of those who are involved in a trust relationship since information acquired by virtue of such a relationship amounts to property subject to the trust obligation.[40] There have even been tentative suggestions that a majority shareholder may owe some kind of fiduciary duty to the company.[41]

In *Canadian Aero Service v. O'Malley*[42] the Supreme Court endorsed the secret profit and conflict of interest principles but emphasised that neither was an exclusive touchstone of liability and that such ethics were flexible and could be applied to new circumstances. This case did seem to clarify that there was liability for insider trading, at least to the issuer, but the practicalities of enforcement meant that it had little effect, since the directors were generally both the persons in breach and those with the power to seek remedies for such breaches.[43] As in the United Kingdom, individual recovery by shareholders is not possible based on the corporate personality doctrine discussed earlier in Chapter One.[44]

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[39] See for example, *Regal (Hastings) Ltd. v. Gulliver* [1942] 1 All E.R. 378, [1967] 2 A.C. 134n (H.L.) adopted by the Supreme Court of Canada in *Zwicker v. Stanbury*, [1953] 2 S.C.R. 438, [1954] 1 D.L.R. 257.
[40] *Boardman v. Phipps* [1966] 3 All E.R. 721, [1967] 2 A.C. 46 (H.L.) confirmed in part by the Canadian Supreme Court in *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592, 40 D.L.R. (3d) 371, 11 C.P.R. (2d) 206.
[41] See Cory J.A. dissenting in *Bell v. Source Data Control Ltd.* (1988), 66 O.R. (2d) 78 (Ont. C.A.) at 86.
[42] *Canadian Aero Service v. O'Malley*, *supra* note 40.
[43] See B.A. Rider and H.L. Ffrench, *supra* note 35 at 117.
[44] The Canadian courts followed English precedent. See *Percival v. Wright* [1902] 2 Ch. 421 (C.A.).

Clearly therefore, as in the United Kingdom, the common law of Canada was found to be lacking with respect to insider trading. The *Kimber Report*[45], discussed below, noted the inadequacies of the common law and recommended that insider trading liability be embodied in statute.

2. *Statutory Prohibition of Insider Trading*

The earliest Canadian statute to attempt to deal with insider trading in some form was the 1934 Dominion Companies Act which contained some basic provisions requiring directors to disclose their interests. Tighter provisions followed the recommendations of a Royal Commission on Price Spreads, which concluded that

> a whole trend of law should be toward putting the managers and directors in a trustee capacity, with respect to all security holders' and that as a necessary first step directors should not be allowed to speculate in the securities of their own issuers and should be required annually to disclose the extent to which they have directly or indirectly purchased their company's shares during the year.[46]

The result was that section 95 of the Act was amended so as to require every director of a public Dominion company, to provide the secretary of the Company with an annual report disclosing all transactions in the Company's shares for presentation at the annual general meeting of the shareholders.[47] Directors were also forbidden from speculating in the company's securities for their own account.[48] Failure to comply with these provisions led to the risk of criminal penalties (a fine in the amount of $1000 and/or six months imprisonment), but there were no civil sanctions.

Such provisions today seem naive and obviously ineffective. The annual reports submitted by directors were only made available to shareholders at the annual general meeting if they requested them. Moreover, the utility of reports on trading so far after the

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[45] Kimber Report *supra* note 10.
[46] *Report of the Royal Commission on Price Spreads*, Toronto, 1935 at 45.
[47] *Companies Act Amendment Act* 1935, s. 29A.

event could only be of limited use – namely exposing a maverick director - and by that time, shareholders would have already lost out. In any case, there were no prosecutions allegedly due to the uncertainty as to what the term "speculation" meant.[49]

A later Royal Commission on Banking and Finance recommended the adoption of a provision similar to section 16(a) of the U.S. Securities and Exchange Act 1934.[50] The Commission also thought that the Provincial securities commissions and the stock exchanges should make greater efforts to prevent the dissemination of information and rumours. They also expressed some support for the introduction of a civil remedy.

A year later, a report was published by the Ontario Royal Commission on the Investigation into Trading in the Shares of Windfall Oils.[51] The Ontario Commission found significant evidence of insider trading and exposed the shortcomings of the Ontario Securities Commission and the Toronto Stock Exchange when it came to regulating the practice. Not only were these bodies inept in their regulatory roles, but the Commission found that the Director of the OSC, John Campbell, and his wife had themselves been engaged in insider trading.[52]

In 1963, a committee was appointed by the Attorney-General of Ontario to study securities regulation in the Province, and in particular to examine the problems of take-over bids and insider trading, and also to consider disclosure of information to shareholders.[53] The report published by the committee, called the Kimber Report after its chairman, radically shaped securities law not only in Ontario, but ultimately across the whole of Canada.

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[48] *Ibid*, s.96A(2)..
[49] B.A. Rider and H.L. Ffrench, *supra* note 35 at 118.
[50] *Report of the Royal Commission on Banking and Finance*, Toronto, 1964, at 351.
[51] *Report of the Ontario Royal Commission on the Investigation into Trading in the Shares of Windfall Oils*, Toronto, 1965.
[52] *Ibid* at 43-50.
[53] Kimber Report *supra* note 10.

The philosophy of the report was clear with respect to insider trading. It considered that although it was not improper per se for an insider to buy and sell securities in his own company, it was improper for an insider "to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company".[54] Moreover, the Committee considered that the common law did not adequately protect investors from insider trading. It was suggested that the primary means of protecting investors should be disclosure of insiders' transactions as in the United States, but it was also recognised that disclosure alone was not enough.

In view of its findings, the Committee made two primary recommendations. First, it recommended the enactment of a provision that would provide investors with a civil remedy where they had suffered loss as a result of insider trading. Secondly, it proposed that a provision be enacted which would render insiders accountable to their company for profits made by trading in its securities.[55]

The report defined insider trading as "purchase or sales of securities of a company effected by or on behalf of a person whose relationship is such that he is likely to have access to relevant material information concerning the company not known to the general public".[56] The Committee was also careful to define 'insiders' believing that the first regulatory step should be a cautious one lest the securities markets be unduly restricted. The main objective was to ensure that officers of companies be caught by the provision:

> The definition should be broad enough to cover those members of management who have access to confidential information and to take part in the formation of

[54] *Ibid* at paragraph 2.02.
[55] *Ibid* at paragraphs 2.21 to 2.26.
[56] *Ibid* at paragraph 2.01.

> corporate decisions, but narrow enough to exclude junior officers whether they have access to confidential information or not.[57]

This approach is interesting since it effectively rejects the theory that investors should all have equal access to information. By excluding junior officers and those other persons who similarly may have access to information about the issuer company, there remain numerous opportunities for insider trading under this definition.

The Committee's definition in fact probably protects the company more than it protects other investors. Under the definition, insiders would have no incentive to take corporate decisions purely in order to make a gain from trading on inside information about that decision. However, other investors would still suffer losses from insider trading. Worse still, a situation would be created whereby some investors will be able to recover their losses but some will not, simply because they traded with senior and not junior officers.

More controversial still was the Committee's recommendation that professional advisors be excluded from the definition of insider. The Committee considered that adequate sanctions for insider trading could be provided for by the professional bodies of those advisors. Again though, the investor would not be able to recover where he had suffered loss by virtue of the insider trading of an advisor to the company.

Similarly, the Committee recommended that persons not connected with the company but connected with the insider, for example a senior officer's family, should not fall within the definition of insider, nor be bound by the insider reporting requirements. Clearly, this recommendation was absurd, offering the defined insiders a clear and easy way in which to circumvent the rule by trading in the name of their spouse. It also of course excludes other tippees, so that the defined insider may still tip his business associates and friends who may then trade on the information without liability. The

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[57] *Ibid.*

reason for the exclusion of tippees according to the secretary of the Committee was as follows:

> The purpose of the Kimber Report in this area was to achieve a fair measure of equity without too great a loss of precision.... To include tippees in the liability provisions might well have, at this stage in the development of our law, created undue uncertainty as to the concept of improper trading, a concept at the moment in the embryonic stage of its evolution.[58]

Rider and Ashe point out another surprising flaw.[59] Despite the fact that the Committee had been appointed largely due to concerns about insider trading in take-over situations, the anti-insider trading provisions did not extend to securities traded in other companies. Thus, even a senior officer of a company could trade freely in the securities of a company that was being targeted for take-over by his own company. Of course this is a classic insider trading situation, and failure to provide for it was a serious inadequacy.

The shortcomings of the recommended prohibition were surprising in view of the stated policy reasons for its imposition. First, the Kimber Report[60] expressly stated the prohibition to be necessary in the interests of investor protection. Secondly, it emphasised that it was required in order to maintain efficient capital markets. The latter it defined as being achieved when the maximum amount of information about a company is available to investors, and that information is potentially available to all investors. The Committee stated their argument to be as follows:

> The ideal securities market should be a free and open market with the prices thereon based upon the fullest knowledge of all relevant facts among traders. Any factor which tends to destroy or put in question this concept lessens the

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[58] Crawford, "Insider Trading" 8 Canadian Bar Journal 400 at 410.
[59] B.A. Rider and H.L. Ffrench, *supra* note 35 at 119.
[60] Kimber Report *supra* note 10.

> confidence of the investing public in the market place, and is, therefore, a matter of public concern.[61]

Given this ambitious aim, it is surprising that the Committee did not go further in their recommendations. It is difficult to see how investor confidence could be much improved when the opportunities for insider trading were still plentiful under the proposed prohibition, nor how such a narrow limitation on insider trading could have any appreciable effect on the efficiency of the capital markets and thereby improve public confidence in the market place.

Nonetheless, the reaction to the Kimber Report[62] was positive, and its recommendations were enacted in most provinces, and even influenced the legislation in other countries.[63] In 1966 new legislation was promulgated in Ontario. Within two years, Alberta, British Columbia, Saskatchewan and Manitoba had copied the legislation.[64] The result was that the legislative controls over insider trading in Canada at a provincial and federal level ultimately became based on similar principles, namely that insiders are under an obligation to report their ownership of and transactions in, securities held in their companies.[65] Additionally, liability may arise if insiders make use of confidential information for their own benefit or advantage.[66]

It is interesting that regulation against insider trading came so late in the day in Canada. Johnston suggests that ultimately this may have been because it was simply neglected:

> It is surprising that regulation of [insider trading] has come so late to the securities markets. Perhaps self-censoring business ethics operated as a partial

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[61] *Ibid* at paragraph 2.02.
[62] *Ibid.*
[63] See B.A. Rider and H.L. Ffrench, *supra* note 35 at 119.
[64] *Securities Act, 1967*, S.A. 1967, c. 76; *Securities Act, 1967*, S.B.C. 1967, c. 45; *Securities Act, 1967*, S.S. 1967, c. 81; and *Securities Act, 1968*, S.M. 1968, c. 57.
[65] See further, Minister of Supply and Services Canada, *Proposals for a Securities Market Law for Canada, Volume 3*, (Ontario: Consumer and Corporate Affairs Canada, 1979) at 630.
[66] *Ibid.*

> sanction on some the most flagrant kinds of [insider trading]. Or perhaps the virtual impossibility of devising a complete cure was a disincentive to attempt any regulation. In addition, regulating [insider trading] was seen as prohibitively expensive and, arguably, fairly ineffective. Most likely, however, [insider trading] regulation was simply neglected.[67]

He also notes his approval of regulation, despite the heavy compliance costs associated with it:

> Despite some of the criticisms of [insider trading] regulation, we believe that it is an important regulatory area, from both the investor protection and market confidence viewpoints.[68]

3. Insider Trading in Ontario

The Kimber Report[69] took the view, as has already been noted, that insider trading would be most effectively eliminated using two strategies. First, all insiders should be required to file insider trading reports. Secondly, there should be liability in cases of abuse by insiders of confidential information.

a) Reporting Requirements

Several reasons have been put forward in support of reporting requirements. Yontef describes these as follows:

> There are several reasons for imposing a reporting obligation upon insiders of a company. An insider's report may serve as evidence for purposes of legal proceedings in that a regulatory body or a party seeking to impose insider trading liabilities will have access to the reports of an insider's transactions. The fact that an insider must report and the act of reporting itself may have salutary effects since the insider discloses and publicizes his trades in the company's securities. Public reporting furnishes the market with the insider's assessment of his company's securities and the information in these reports may affect the

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[67] See Johnston *supra* note 1 at 133 (footnotes omitted).
[68] *Ibid* at 133 note 15.

> market's evaluation of the securities. Insider reporting, therefore, constitutes the material disclosure for purposes of potential liability but it may have greater impact by virtue of its effects on the insider and others in the market.[70]

The Kimber Report took the view that reporting obligation would increase investors' confidence in the integrity of the markets.[71] To achieve this goal, summaries are published by the securities Commissions of the various provinces.[72]

The essence of the reporting requirement is that insiders[73] must file reports detailing the securities that they hold in their company, and details of any transactions in which they are involved concerning their company's securities. These reports must be filed within a certain time period. Unfortunately, these time periods vary substantially from province to province. In Quebec for example, reports must be filed within ten days of becoming an insider,[74] whereas in Ontario reports need not be filed until ten days after the end of the month in which one becomes an insider[75]. Similarly, any change in holdings must be reported within ten days of the change in Quebec[76], but in Ontario must be filed within ten days after the end of the month in which the change took place[77]. This makes compliance overly complicated. There seems to be no logical reason why a procedural requirement such as this could not be co-ordinated more effectively. Moreover, the time periods are probably too long to be of any real use to other investors. Johnston notes:

> In the light of technological and communications advances, 10 days is too long. Institutional investors (and many lay investors) would appreciate more contemporaneous knowledge of insiders' trading activities. In any event, 10

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[69] Kimber Report *supra* note 10.
[70] *Supra* note 65 at 631-2 (footnotes omitted).
[71] Kimber Report *supra* note 10 at paragraph 2.02.
[72] See for example the OSA *supra* note 11 at s. 120. This section requires that the Commission summarise the information in a monthly periodical. The summaries are also published in some business publications.
[73] The definition of 'insider' is discussed in detail *infra*.
[74] Quebec *Securities Act*, R.S.Q. 1977, c.V-1.1 (as amended) [hereinafter QSA] s. 96.
[75] OSA *supra* note 11 s. 107(1).
[76] QSA *supra* note 74 s. 97 and Quebec Securities *Regulations*., s. 174.
[77] OSA *supra* note 11 s. 107(2).

> days after the end of the month is far too long. For example, a trade on the first of the month need not be reported until almost six weeks later.[78]

The usefulness of the reporting requirement is further weakened by the fact that exemptions are made by the Commissions from filing. Exemptions may follow the initiative of the Commission itself or may be granted at the requested of an insider. Furthermore, the grounds which may justify an exemption are fairly broad. They may be granted if reporting would cause a conflict with the issuer's laws of incorporation or if the Commission considers there to be other "adequate justification" for the exemption.[79]

b) Liability for insider trading

The prohibition against insider trading is set out in the Ontario Securities Act at s. 76. This section prohibits the sale or purchase of securities in a reporting issuer if the seller or buyer has knowledge of an undisclosed material fact or change with respect to the issuer. It further prohibits tipping, and deals explicitly with take-over situations. The section relating to insider dealing in the OSA is noticeably brief, but is fairly comprehensive, and goes much further in fact than the Kimber Report recommendations. It is now analysed subsection by subsection.

(1) The Prohibition against Dealing

Section 76(1) contains the dealing prohibition:

> No person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.

Clearly the definitions are key to understanding the extent of the section. As part of the OSA, the main definitions used appear at the beginning of the Act.[80] However, there are

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[78] Johnston *supra* note 1 at 140.
[79] See OSA *supra* note 11 s. 121(2).
[80] *Ibid* at s. 1(1).

also specific definitions in section 76(5) that relate only to this insider trading section. Thus, the definition of the insider, namely, a "person or company in a special relationship with a reporting issuer" is defined separately,[81] as is the definition of a "security"[82]. The key definitions are now considered.

(a) INSIDE INFORMATION

The OSA does not use the phrase 'inside information' as such. However, the OSA prohibits insiders and tippees from dealing on the basis of "a material fact or material change with respect to the reporting issuer that has not been generally disclosed", which is basically 'inside information' as we generally understand it. It is a layered definition that merits a word by word analysis.

One of the key parts of the definition is materiality, since only the knowledge of material facts or changes will prevent an insider from dealing. Both "material facts" and "material changes" are defined at section 1(1) of the OSA and are therefore general definitions that are relevant throughout the Act. They are particularly relevant, for example, to a reporting issuer since it must file a "Material Change Report" whenever there is a "material change" in its affairs.[83]

A "material change", where used in relation to the affairs of an issuer, is:

> a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable.[84]

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[81] *Ibid* at s. 76(5).
[82] *Ibid* at s. 76(6).
[83] *Ibid* at s. 75(2) and National Policy No. 40 ("Timely Disclosure").
[84] OSA *supra* note 11 s. 1(1).

A "material fact", where used in relation to securities issued or proposed to be issued, means:

> a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities.[85]

The problem with any materiality definition, is always that of hindsight. The courts considering whether or not a fact was or was not material, will always have the benefit of it. However, the insider, when trying to decide whether or not to trade, will not. In this definition, the problem is attenuated by the fact that there is a reasonableness requirement.

It is not aided though by the lack of clarity over the meaning of "significant effect". However, whether or not precision would or would not be helpful here is debatable. Defining "significant" as a ten percent change for example would give an insider no clearer idea of whether or not he should trade, since such a change would be too difficult to predict. On the other hand, a fixed percentage change would render an element of objectivity to a largely subjective section. Another cause of uncertainty is that a "material change" includes decisions that are unconfirmed. This is, though, the only approach to take, since otherwise insiders would be able to deal just before a board decision and would thereby escape liability.

Additionally, the definition is broad because there is no limitation on what a "fact" or "change" is. For example, a fact need not be specific or precise. Similarly, the fact need not even relate to the issuer as long as the issuer's securities could be affected. This means that information regarding a change in government policy, likely to affect a whole sector's securities would still be inside information. Arguably, even information pertaining to securities in general would be inside information as long as the securities were bought in an issuer of which the trader was an insider. Indeed, under this definition

[85] OSA *supra* note 11 s. 1(1).

any fact is covered as long as it could reasonably be expected to affect the price of the issuer's securities.

There can be no liability for trading on inside information if that information has already been "generally disclosed".[86] There is no definition in the Act of general disclosure, however Johnston offers a suggestion. He considers that since "disclosure" is effected through continuous disclosure methods, "general disclosure" must be a broader concept. Otherwise an insider would be unduly restrained from trading on information which has been widely discussed in the press but that has not actually been officially disclosed by the issuer.[87]

It is worth noting at this point the well-publicised Quebec case, *L'Affaire Blaikie*.[88] Blaikie was a leading Montreal lawyer as well as a former president of the Progressive Conservative Party of Canada and former candidate for leadership of the party. The case involved Memotec, a CBCA corporation, and Teleglobe, a Crown corporation and at the time the sole authorised operator of Canada-overseas telecommunications services. In 1984 and again in 1986 the Progressive Conservative government had announced its intention to dispose of Teleglobe. In short, Blaikie had knowledge of the fact that Memotec had deposited a bid for Teleglobe, and on discovering that fact, purchased shares in Memotec. Blaikie did not know however the terms of the bid or even the price to be paid. The question arose as to whether or not such information amounted to inside information, or "privileged information/information privilegiée" under the Quebec Securities Act.[89]

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[86] OSA *supra* note 11 s. 76(1).
[87] Johnston *supra* note 1 at 143.
[88] *Commission des Valeurs Mobilieres Mobilières du Québec v. Blaikie* (April 15, 1988, Que. Ct. Sess.) Montreal 500-27-014769-873, Lagacé J.S.P.. Available on SOQUIJ under number 88-636.
[89] QSA *supra* note 74.

At that time, the Quebec Act defined "privileged information" as "any information concerning a material fact not yet known to the public that could affect the value or the market price of securities of an issuer/ toute information concernant un fait important, encore inconnue du public et susceptible d'affecter la valeur ou le cours des titres d'un émetteur".[90] The Quebec provision is not dissimilar from the Ontario provision in that it is dependent on an undefined concept, namely "material fact". In this case, the information that Blaikie had was imprecise and largely inconclusive, as he did not know whether or not the bid would be accepted. In fact the case was described as falling "close to the line" in that liability was not clear cut.[91]

In any case, in the absence of Canadian authority on point, the court relied on the definition used by the U.S. Supreme Court in *T.S.C. Industries Inc. v. Northway Inc.*[92] which was that a fact would be material if a reasonable investor would have viewed it as having significantly altered the "total mix" of information made available to him.

The leading Canadian case now with respect to materiality is *Pezim v. British Columbia (Superintendent of Brokers)*.[93] In that case, the Securities Commission found that the defendants had failed to make timely disclosure of material changes and also had traded on the basis of those undisclosed material changes. The relevant information related to a drilling report that revealed the presence of ore in the ground. Such information is classic inside information as its disclosure would inevitably have an impact on the stock price of a mining company.

The British Columbia Court of Appeal ("BCCA") however, with the exception of Locke J.A., did not agree. It found that the information was not a material change but rather that

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[90] QSA *supra* note 74 s. 5.

[91] R.L. Simmonds, "Penal Liability for Insider Trading in Canada: Commission des Valeurs Mobilières du Québec v. Blaikie" (1988) 14 Canadian Business Law Journal 477 at 493.

[92] *T.S.C. Industries Inc. v. Northway Inc.* (1978), 426 U.S. 438.

[93] *Pezim v. British Columbia (Superintendent of Brokers)* [1994] 2 S.C.R. 557, 114 D.L.R. (4th) 385.

it was a material fact, since the ore had always been in the ground and the fact of its discovery was therefore not a change. This meant that there had been no duty to disclose the information and the BCCA overturned the Securities Commission's decision. The result was clearly surprising since this kind of information was obviously the kind of information at which the legislation was aimed since such information was exactly the kind of information which would affect an investor's decision to purchase shares in a company.

The Supreme Court of Canada sensibly overturned the decision which confounded a common sense interpretation of the provision and ruled not only that the BCCA did not have the authority to overturn a decision by the Securities Commission on this point, but also that its decision was "clearly wrong" and was inconsistent with the "economic and regulatory realities" that the British Columbia Securities Act had set out to address.[94]

(b) THE INSIDER

The definition of 'insider' for the purposes of this insider trading section goes beyond the definition of "insider" which appears in the general definitions section of the Act. The prohibition against dealing on the basis of inside information applies to any "person or company in a special relationship with a reporting issuer". This phrase is defined at section 76(5). It means:

> (a) a person or company that is an insider, affiliate or associate of,
>
> (i) the reporting issuer,
>
> (ii) a person or company that is proposing to make a take-over bid, as defined in Part XX, for the securities of the reporting issuer, or
>
> (iii) a person or company that is proposing to become a party to a reorganization, amalgamation, merger or arrangement or similar business

[94] *Ibid* at 600.

combination with the reporting issuer or to acquire a substantial portion of its property,

(b) a person or company that is engaging in or proposes to engage in any business or professional activity with or on behalf of the reporting issuer, or with or on behalf of a person or company described in subclause (a) (ii) or (iii),

(c) a person who is a director, officer or employee of the reporting issuer or of a person or company described in subclause (a) (ii) or (iii) or clause (b),

(d) a person or company that learned of the material fact or material change with respect to the reporting issuer while the person or company was a person or company described in clause (a), (b) or (c),

(e) a person or company that learns of a material fact or material change with respect to the issuer from any other person or company described in this clause, and knows or ought reasonably to have known that the other person or company is a person or company in such a relationship.

With reference to subsection (a) "a person or company in a special relationship with a reporting issuer" means: -

(a) every director or senior officer of a reporting issuer,

(b) every director or senior officer of a company that is itself an insider or a subsidiary of a reporting issuer,

(c) any person or company who beneficially owns, directly or indirectly, voting securities of a reporting issuer or who exercises control or direction over the voting securities of a reporting issuer or a combination of both carrying more than 10 per cent of the voting rights attached to all voting securities of the reporting issuer for the time being outstanding other than voting securities held by the person or company as underwriter in the course of a distribution, and

(d) a reporting issuer where it has purchased, redeemed or otherwise acquired any of its securities, for so long as it holds any of its securities.

Subsection (a) therefore encompasses the traditional insiders (such as directors and senior employees) as well as potential bidders in take-over or merger situations. It does not however apply to persons who have actually made bids. Subsection (b) brings the issuer's advisors within the ambit of the provision. For example, lawyers and accountants who are party to inside information, may not trade in the issuers' securities. Subsection (d) covers persons who were insiders in the past. The last subsection is the tippee provision. A tippee is only liable if he has knowledge that his source is an insider or ought reasonably to have known that fact.

(2) The Prohibition Against Tipping

Section 76(2) headed "[t]ipping" prohibits issuers and insiders from tipping others: -

> No reporting issuer and no person or company in a special relationship with a reporting issuer shall inform, other than in the necessary course of business, another person or company of a material fact or material change with respect to the reporting issuer before the material fact or material change has generally been disclosed.[95]

Essentially this provision prevents any kind of improper disclosure. There is no requirement that the tipper tip a person who is likely to trade: the insider simply must not disclose inside information.

Section 76(3) extends the tipping provision to persons who intend to take over the issuer, persons who propose to merge or enter into a "similar business combination" with the issuer, or those who intend to acquire a substantial portion of the issuer's property.[96]

c) Defences

The only defence available under the OSA is for an individual to show that he reasonably believed that the inside information on which he traded, had already been generally disclosed.[97] The defence is available for all of the trading and tipping offences, but the burden of proof rests with the insider. Moreover, there will be no defence where the disclosure of the information was partial only. For example, dislosure that the

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[95] OSA *supra* note 11 at s. 76(2).
[96] *Ibid* at s. 76(3).
[97] *Ibid* at s. 76(4).

information existed is not enough, nor would be disclosure only of part of the information.[98]

d) Sanctions

(1) Penal Sanctions

A person found guilty of insider trading is liable to a imprisonment for up to two years under section 122(1)(c) which is the general sentence for any contravention of Ontario securities law. That person may also or instead be liable to pay a fine of not less than the profit he made or the loss he avoided, but not more than the greater of CDN$1,000,000 or three times the profit made or loss avoided by that person.[99]

To summarise, in order to obtain a conviction for the trading offence, the prosecution would need to prove the following four elements of the crime:

1. The defendant was in a special relationship with the reporting issuer;
2. The defendant purchased or sold securities of that reporting issuer;
3. The defendant traded in those securities with knowledge of material information concerning the affairs of that reporting issuer; and
4. That material information had not been generally disclosed.

In order to obtain a conviction for the tipping offence, the prosecution would need to prove the following:

1. The defendant was in a special relationship with the reporting issuer;
2. The defendant informed another person of material information about that reporting issuer; and
3. The defendant informed that person before that material information had been generally disclosed.

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[98] See *Green v. Charterhouse Group Canada Ltd.* (1976), 12 O.R. (2d) 280 (C.A.); affirming [1973] 2 O.R. 677, 35 D.L.R. (3d) 161 (H.C.).
[99] OSA *supra* note 11 at s. 122(4).

The defendant would not be liable for the tipping offence if he shows that the information was given in the necessary course of business. He would not be liable for either offence if he shows that he reasonably believed that the information had already been generally disclosed.

(2) Remedies for Damaged Parties

A person who trades with an insider and thereby suffers a loss as a result of the transaction, may recover damages.[100] Such person who traded with the insider must prove the same elements as the prosecution when proving the trading offence. The same defence of reasonable belief in the general disclosure of the information is available in addition to the defence that the plaintiff knew or ought reasonably to have known the relevant information.[101]

An action for damages can also be brought against the tipper.[102] The plaintiff must prove the same elements as the prosectution in the tipping offence, and the same defences are available.

When assessing damages the court is required to consider the difference in price at which the plaintiff bought or sold the securities and the average general market price of the securities in the twenty days that follow general disclosure of the information.[103] The court is at liberty to consider any other measure of damages it considers to be relevant.[104]

(3) Remedies for the Issuer

Any insider trader or tipper is liable to the issuer for the trades made in the issuer's securities. The only defence available is for the insider to prove that he believed the

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[100] *Ibid* at ss. 134(1) and (2).
[101] *Ibid* at s. 134(1)(b).
[102] *Ibid* at s. 134(2).
[103] *Ibid* at s. 134(6).
[104] *Ibid* at s. 131(6)

information was generally disclosed, or that he gave the information in the necessary course of business for an action against a tipper.[105] The action is for the accounting to the issuer for any benefit or advantage received by the insider, affiliate, associate or tippee. Where the issuer does not bring an action, the Securities Commission or any security holder of the issuer, either presently or at the time of the trades, may make an application to the court to bring an action on behalf of the issuer to enforce the duty to account.[106] The court may make an order requiring the Commission or authorising the security holder to bring such action if it is satisified that there are:

1. Reasonable grounds for believing that the issuer has a cause of action, and
2. The issuer has failed to diligently continue an action brought by it, or to diligently commence an action within 60 days of being requested to do so by the Commission or the security holder.[107]

The court may at its discretion consider other factors, such as whether or not such an action would be in the best interests of the issuer. It may also order the issuer to pay all reasonable costs incurred by the security holder or the Commission as a result of bringing or continuing such action.[108]

(4) Administrative Sanctions

The Commission may also impose the following administrative sanctions:

(a) ADMINISTRATIVE ORDER

The Commission may make an "administrative order" against the offender if it considers that it is in the public interest to do so.[109] An administrative order is not a sanction which is specific to insider trading but is rather a general power granted to the Commission to sanction breaches of OSA.

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[105] *Ibid* at s. 134(4).
[106] *Ibid* at s. 135(1).
[107] *Ibid.*
[108] *Ibid* at s. 135(4).
[109] *Ibid* at s. 127(1).

(b) CEASE TRADE ORDER

The Commission may make an order for the offender to cease trading.[110] Such an order may be imposed temporarily pending an application for a cease trade order for a longer period.

(c) REMOVAL OF EXEMPTIONS

The Commission may remove any exemptions to which the offender would ordinarily be entitled to if it considers that it is in the public interest to do so.[111]

(d) SUSPENSION OF REGISTRATION

The Commission may issue an order suspending registration of the offender with the Commission.[112]

(e) PROHIBITION FROM ACTING AS A DIRECTOR OR OFFICER

The Commission may apply to the court for an order to prohibit an offender from acting as a director or officer of a company if it can show that such prohibition is in the public interest.[113]

(f) DECLARATION OF NON-COMPLIANCE

The Commission may apply to the court for a declaration that the offender is not in compliance with Ontario securities law.[114] The court then has wide remedial powers under section 128(3), including the power to order a disgorgement of profits.

4. The Bennett/Doman Case

One of the most notorious insider trading cases in Canada was the Bennett/Doman Case, which lasted for ten years and has exposed the flaws of Canadian regulation of insider

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[110] *Ibid* at s. 127(1)2.
[111] *Ibid* at s. 127(1)3.
[112] *Ibid* at s. 127(1)1.
[113] *Ibid* at s. 128(3)7 and 8.
[114] *Ibid* at s. 128(1).

trading. The case involved Bill Bennett, a former premier of British Columbia, his brother Russell Bennett, and Herb Doman a Vancouver businessman and friend of theirs. Herb Doman controlled and directed Doman Industries Limited ("Doman Industries"), a British Columbia company.

In 1988, a large American corporation, Louisiana Pacific Corporation ("Louisiana Pacific") expressed an interest in acquiring Doman Industries. It was alleged that Russell Bennett purchased shares in Doman Industries with inside information the potential take-over. It was also alleged that Bill Bennett, Russell Bennett and Herb Doman all sold shares in Doman Industries based on inside information that negotiations with Louisiana Pacific had been terminated.

The allegations were largely based on circumstantial evidence. On November 4, 1988, Louisiana Pacific informed Herb Doman by telephone that the take-over negotiations were to be terminated. Immediately following that telephone call, telephone records showed that a call was made from the Doman offices to the offices of the Bennetts. There was no way of showing who had actually received that telephone call. Within minutes of that telephone call however, the Bennetts had disposed of their significant shareholdings in Doman Industries.

In a quasi-criminal trial before the courts in British Columbia, the prosecution understandably alleged that the telephone call had been made by Herb Doman to either Bill or Russell Bennett. They further alleged that the nature of that call was that it was a tip of inside information, namely informing them of the aborted take-over negotiations. The prosecution also alleged that the Bennetts had sold their shares on the basis of that tipped information before it had been made public and thus before the share price had fallen. The British Columbia Securities Commission made the same allegations in an administrative hearing.

In the quasi-criminal trial[115], the British Columbia Provincial Court found that the prosecution had not proved its case beyond reasonable doubt, nor even on a balance of probablities. This was because the prosecution had only been able to offer circumstantial evidence, which, however damning it may have been, was not direct evidence and was therefore insufficient to convict the defendants.

In addition to the administrative trial by the British Columbia Securities Commission ("BCSCn"), the Ontario Securities Commission ("OSC") also initiated an action against the defendants. The OSC was justified in so-doing because Doman Industries was a reporting issuer in Ontario as well as in British Columbia. The OSC laid charges for insider trading and set a date for the hearing.[116] Because of concerns relating to double jeopardy, the OSC was forced to withdraw all criminal charges.[117]

However, Doman and the Bennetts did not accept the OSC's administrative jurisdiction and refused to attend or testify. The OSC then applied to the Ontario High Court of Justice for an order to compel the defendants to attend and testify which was declined on the grounds that the OSC did not have jurisdiction outside Ontario and an appeal was dismissed.[118] The OSC subsequently abandoned its proceedings against the defendants.

The BCSCn ultimately though found all three defendants liable for insider trading although the proceedings were long and drawn out. This was as a result of the several appeals by the defendants made to the British Columbia Court of Appeal, to the Supreme Court of British Columbia and ultimately to the Supreme Court of Canada on various points.[119] Because the BCSCn's hearing was of an adminstrative nature, the defendants

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[115] *Bennett* [1989] B.C.J. No. 1884.
[116] *Bennett* (1989) 12 O.S.C.B. 600 and (1989) 12 O.S.C.B. 2536.
[117] *Ibid.*
[118] *Bennett* (1999) 13 O.S.C.B. 505 and *OSC v. Bennett* (1991), 1 O.R. (3d) 576 (C.A.).
[119] The references for the various appeals which were founded on a variety of grounds, including bias of the Securities Commission, are as follows: *Bennett v. British Columbia (Securities Commission)* (1991), 82 D.L.R. (4th) 129 (B.C.S.C (1992), 94 D.L.R. (4th) 339 (B.C.C.A.); (1992), 97 D.L.R. (4th) vii; [1996] B.C.J.

were compelled to testify and therefore explain the nature of the telephone conversation. They claimed that the conversation had related to a racing horse, which, unsurprisingly, did not convince the Commission.

The BCSCn imposed several sanctions. All three defendants were forced to resign from their positions as directors or officers of reporting issuers and were prohibited from so acting for a period of ten years. The apparent harshness of this sanction in respect of Doman was lessened by the surprising concession that he be permitted to remain as a director of Doman Industries provided that his actions be supervised by independent directors. All three were required to pay costs and an administrative penalty.

5. *Comment*

In 1993, then only five years into the Bennett/Doman case, Jordan described the saga as "an embarrassment, but an instructive one" and said that it was "symptomatic of a regime in crisis".[120] Jordan states that the Ontario *Securities Act* is badly in need of reform and that its inadequacies lead to "legislative deadlock" across Canada because the Act serves as a model for securities legislation in the other provinces.[121]

However, the inefficacy of criminal proceedings for sanctioning insider trading is not peculiar to Canada since the nature of the offence is such that it is very difficult to prove. In fact any jurisdiction which requires proof of crimes beyond all reasonable doubt would struggle to convict defendants on the basis of the only proof that is often available, namely circumstantial evidence. In fact, cleverer defendants could have eliminated the very little proof that the prosecution had in this case, namely the telephone records.

No. 603; *Bennett v. British Columbia (Superintendent of Brokers)* (1993), 77 B.C.L.R. (2d) 145 (B.C.C.A.); (1993) 87 B.C.L.R. (2d) 22 (B.C.C.A.); (1994), 91 B.C.L.R. (2D) xxxvi; (1994) 30 Admin. L.R. (2d) 283 (B.C.C.A.); (1994), 118 D.L.R. (4th) 449 (B.C.C.A.); [1996] B.C.J. Nos. 2631 and 2632.; *Doman v. British Columbia (Superintendent of Brokers)* (1997) 12 C.C.L.S. 186; and (1996) 12 C.L.L.S. 282.

[120] C. Jordan, "Lessons from the Bennett Affair" (1993) 38 McGill Law Journal 1071 at 1072.

[121] *Ibid* at 1073.

Without such records evidence of insider trading would be little more than a series of fortunate coincidences for the trader.

In Canada particularly though there is probably a stronger case than other countries for avoiding penal liability for insider trading. That is simply because insider trading in Canada is not generally viewed as being a very serious offence. Simmonds notes such an attitude in his article about the Blaikie Affair:

> There is good reason to think the insider trading standard is neither as well understood nor as deeply felt by the business community as say the standards that oppose theft or fraudulent misstatement, perhaps because the norm seems concerned with the unfairness rather than the taking of property.[122]

If this is the case, then the imposition of penal liability may well be inappropriate. Criminal sanctions should be reserved for that conduct which society deems to be the most harmful and reprehensible. Where conduct is not so viewed, criminal sanctions should be avoided as the likelihood is that the courts will share such views and will avoid convicting defendants, thus making a mockery of the penal system.

If administrative sanctions are more appropriate, they should be adequate so as to prevent future violations. In this respect Canada does suffer more than other jurisdictions because of the nature of its regulatory structure. Whereas in the United Kingdom and the United States there exists a single all powerful regulator which operates at a federal level, in Canada there are several provincial regulators. This means that multiple administrative actions are commenced, which as well as being an inefficient use of resources, means that the defendant is forced to defend several actions based on the same facts. Even if this does not always strictly contravene the double jeopardy principle, it is inherently unfair. Jordan, whilst not calling for a single federal Canadian regulator, recognises that insider

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[122] *Supra* note 91 at 493.

trading is best dealt with at a federal level and calls for both provincial and federal legislative action:

> It is time for legislative action, at both federal and provincial levels. Provincially, it is time for a major overhaul of the *OSA*; the time for occasional tinkering is past. At the federal level, it is time for a recharacterization of issues such as insider trading; insider trading is no longer so much a question of corporate governance, an area where federal interest is fading, as it is a question of market integrity, and area of lively federal interest.[123]

[123] *Supra* note 120 at 1091.

CHAPTER FOUR: INSIDER TRADING IN THE UNITED KINGDOM

I. THE REGULATORY SYSTEM

A. Overview

The United Kingdom operates a system of self- regulation of its markets and its financial services industry.[1] This was established by the Financial Services Act 1986 which gave the Secretary of State for Trade and Industry overall control of the investments industry, but which also delegated many of his powers to a supervisory body: the Securities and Investment Board (SIB).

Beneath the SIB, supervision is divided according to sectors, each sector being governed by its own self-regulatory organisation (SRO). The SROs are independent recognised bodies that are funded by their own members. Currently there are three: the Investment Management Regulatory Organisation (IMRO); the Securities and Futures Authority, and, the Personal Investment Authority (PIA). Professions are governed by registered professional bodies (RPBs) such as the Law Society. The SROs and the RPBs must maintain adequate rules to control their members and to protect the public.

The Financial Services Act also created recognised investment exchanges. The Stock Exchange became one of these. The responsibility of a recognised investment exchange is (*inter alia*) to ensure that business is conducted in an orderly manner so that investors are protected and monitor and enforce compliance with its rules and to investigate complaints. It must also promote and maintain high standards of integrity and fair dealing in the carrying on of investment business.

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[1] See generally, N. Lewin, *Corporate Finance: Public Companies and the City*, (Bristol: Jordans, 1999) at chapters 5-6.

The financial services industry in the United Kingdom is however, currently undergoing major change with the recent creation of a new SEC-style super-regulator: the Financial Services Authority (FSA). The FSA is essentially the old SIB but its powers and jurisdiction have been widened significantly. It will act as a single regulator of all the UK's financial and banking services and has been gradually acquiring the regulatory powers of other institutions including the SROs, the Bank of England and Lloyd's. The transfer of functions commenced in June 1998 and is expected to be complete when the Financial Services and Markets Act 2000[2] (FSMA) comes fully into effect.[3] The FSMA gives the FSA a single set of powers to regulate the financial services industry.

Currently, criminal proceedings for insider trading may only be commenced by the Secretary of State (Department of Trade and Industry) or the Director of Public Prosecutions (the Crown Prosecution Service).[4] The Serious Fraud Office also can bring criminal prosecutions but it does not normally investigate insider trading cases. When the FSMA comes fully into force the FSA will also be empowered to bring criminal prosecutions. This means that there is, and will continue to be, a significant overlap between the authorities. It is envisaged that the existing departments will continue to investigate insider trading but that most cases will be dealt with by the FSA, whose powers will be wider (they will include the power to impose civil sanctions for example). For this reason, the focus of this section is on the FSA.

B. The Financial Services Authority

1. Introduction

The financial services industry represents 7% of gross domestic product and 30% of the value of the FTSE 100 companies. The industry employs around a million people in the

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[2] *Financial Services and Markets Act 2000* (U.K.), 2000, Chapter c. 8 [hereinafter the FSMA].
[3] Under section 431 of the FSMA *ibid*, the operative provisions of the Act will come into force on "such day as the Treasury may by order appoint".
[4] *Criminal Justice Act 1993* (U.K.), 1993, Part V, s. 61 [hereinafter CJA].

UK, which is 5% of the total workforce.[5] The importance of the industry to the UK cannot therefore be underestimated, and its continued success is of prime importance to the country. There are many reasons why the industry is strong, but it is widely believed that much is due to its reputation for fair dealing.[6] Historically, this was so because the City was little more than a gentlemen's club, with rules and standards of conduct which were followed by its members. This is not the case today, and the continued policy of self-regulation has not been as successful as was hoped in 1986 when the Financial Services Act came into effect.

Indeed, in recent years the City's reputation has been severely tarnished. Pension mis-selling and great financial scandals such as BCCI and Barings have made the headlines. Moreover, the public has been less tolerant of City 'fat cats' whom it is perceived take home unjustified salaries and bonuses, and who indulge in unscrupulous practices. As a result, the 'intellectual consensus' was that thorough regulatory reform in the UK was necessary.[7]

The consequence of the discontent (and a new Labour Government thirsty for reform) was the launch of the FSA on 28 October 1997. London is the first major market to attempt the creation of a single financial regulator, which it is believed will offer "significant improvements in operating efficiencies, in consumer responsiveness, and in sensitivity to the market"[8]. The concept has been a controversial one however: there is

[5] "The Establishment of the Financial Services Authority" (28 October 1997), http://www.sib.co.uk/launchdc/lncover.htm (date accessed: 30 June 1998) at para. 3.
[6] "New Insider Dealing Law from 1 March" (1 February 1994), http://www.ns.hm-treasury.gov.uk (date accessed: 24 June 1998) at para. 3.
[7] See A. Hilton, "The New Financial Services Authority: Plans for Implementation" (1998) 6 Journal of Financial Regulation and Compliance 150 at 151-2.
[8] "New Regulator Launched" (28 October 1997), http://www.sib.co.uk/press/fsa.htm (date accessed: 24 June 1998) at para. 6.

concern that the amalgamation of various institutions will lead to a clash of cultures.[9] The Government has though been praised for its extensive consultation with the sector:

> This is an astonishingly open process, and practically every think-tank and independent commentator has had a say. The Centre for the Study of Financial Innovation (CSFI) has, for instance, already been involved in the debate for a couple of years, sponsoring several conferences on regulatory reform and holding half a dozen round tables.[10]

The creation of the FSA was a three stage process. The first stage was its launch when the SIB was renamed the FSA. The Secondly stage was more radical. The Bank of England Act 1998[11] transferred from the Bank to the FSA responsibility for supervising banks, listed money market institutions and related clearing houses. The third stage, and most relevant to insider trading, has just taken place. The FSMA has created a statutory regime under which the FSA will acquire the regulatory and registrative functions currently exercised by the SROs, the Department of Trade and Industry's Insurance Directorate, the Building Societies Commission, the Friendly Societies Commission, and the Register of Friendly Societies. It has also given the FSA responsibility for the authorisation of firms currently authorised to do investment business by virtue of the membership of an RPB.

2. *Legal Status, Funding and Composition*

As already noted, in corporate and legal terms the FSA is the SIB renamed. It is a company limited by guarantee that is accountable to the Treasury. Its funding comes from the industry that it regulates or registers through the raising of fees from regulated

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[9] See R. Sarker, "Reform of the Financial Regulatory System" (1998) 19 Company Lawyer 11 at 13, and see generally J. Scott, "Banking and Securities Regulation: When Two Worlds Collide" (1998) May 1998 Butterworths Journal of International Banking and Financial Law 171.
[10] See A. Hilton *supra* note 7 at 150.
[11] *Bank of England Act 1998* (U.K.), 1998, c. 11, Part III.

firms and recognised bodies (for example, the Stock Exchange).[12] The FSA is headed by a Board, which currently has ten members. The Board's role is to oversee the exercise of its statutory powers, to deal with corporate governance issues, to exercise quality control over the organisation and to handle major issues of policy and standard setting. Beneath the Board is an executive committee, comprising senior members of the Executive, and other committees as required. [13]

3. *Objectives*

The FSA has four clear regulatory objectives, which are set out in Part I of the FSMB. These are market confidence; public awareness; the protection of consumers; and, the reduction of financial crime.[14] The market confidence objective is "maintaining confidence in the financial system", the latter including financial markets and exchanges, regulated activities, and "other activities connected with financial markets and exchanges".[15] The reduction of market crime is "reducing the extent to which it is possible for a business carried on by (a) a regulated person, or (b) in contravention of a general provision, to be used for a purpose connected with financial crime".[16] "Financial crime" is stated to include fraud or dishonesty; misconduct in, or misuse of information relating to, a financial market; and, handling the proceeds of crime.[17] The latter objective means that the FSA will be required to monitor, detect and prevent financial crime, working in co-operation with the criminal authorities.

The market confidence objective is prevalent throughout the FSA's literature. It clearly drives the FSA's policy with reference to market misconduct:

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[12] See further *supra* note 5 at paras. 15-17.
[13] *Ibid* at paras. 19-23.
[14] FSMA *supra* note 2 Part I, s. 2(2).
[15] *Ibid* s. 3.
[16] *Ibid* s. 6(1).
[17] *Ibid* s. 6(3).

> The United Kingdom's position as a world-leading financial centre stems not only from the openness and competitiveness of its markets but also its reputation as a fair place to do business.
>
> Confidence in the fairness of a market enhances its liquidity and efficiency. Market regulations should therefore seek to enhance confidence while not unnecessarily restricting the freedom to trade.
>
> As a general principle, market efficiency is improved by market users trading at times and in sizes most beneficial to them (whether pursuant to long-term investment objectives, risk-management or short-term speculation), and seeking the maximum profit from their dealings.
>
> However, confidence in markets will be undermined if users believe that they have been unreasonably disadvantaged (whether directly or indirectly) by others in the market having misused privileged information or improperly manipulated the market.[18]

4. Functions

The FSA's functions are also clearly set out in the Act. Section 2(4) sets out that its general functions are (a) its rule-making functions; (b) its function of preparing and issuing codes under the Act as a whole; (c) its functions in relation to the giving of advice and guidance; and (d) its function of determining general policy and principles by reference to which it performs particular functions.[19]

5. Powers with Reference to Market Abuse

Part VIII of the FSMA authorises the FSA to take action against market abuse, which includes insider trading. It is required to prepare and issue a code of conduct[20] and has the

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[18] Financial Services Authority, *Consultation Paper 10: Market Abuse, Part 2, Draft Code of Market Conduct* (London: Financial Services Authority, 1998) at 5.
[19] FSMA *supra* note 2 Part I, s. 2(4).
[20] *Ibid* Part VIII, s. 119.

power to impose unlimited penalties on those who abuse the market.[21] This is discussed in more detail later.

II. LIABILITY FOR INSIDER TRADING

A. Introduction

As far back as 1696, insider trading was prevalent in England: Commissioners appointed by Parliament reported that they had discovered conduct that amounted to insider manipulation and insider trading. The Commissioners concluded even then that the practice would undermine the 'Trade of England'.[22] It did not, however, become a criminal offence until 1980.

The Companies Act 1967 first introduced a provision to prevent insider speculation: directors, their spouses and infant children were prohibited from purchasing options in the securities of their company or a related company.[23] Shareholders though traditionally have not been considered to be insiders since it was thought that they did not have privileged access to information, nor any special rights or obligations.

Some attempts were made to argue that insiders induced investment transactions by virtue of a dishonest concealment of a material fact, and therefore a crime is committed contrary to what is now the Financial Services Act 1986[24].[25] However, the main prohibitions of insider trading have traditionally been those imposed by self-regulatory bodies. The *City Code on Takeovers and Mergers* and the *Listing Rules* of the London Stock Exchange have for some time contained provisions intended to combat insider trading. These promote timely disclosure, which reduces insider trading opportunities.

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[21] *Ibid* Part VIII, s. 123.
[22] See B. Rider & M. Ashe, *Insider Crime: the New Law*, (Bristol: Jordans, 1993) at 2.
[23] *Companies Act 1967*, (U.K.), 1967. See now *Companies Act 1985*, (U.K.), 1985 ss. 323 and 327.
[24] *Financial Services Act 1986*, (U.K.), 1986, s. 47(1).
[25] B. A. K. Rider, C. Abrams & M. Ashe, *Guide to Financial Services Regulation*, 3rd ed. (Bicester: CCH Editions, 1997) at 217-8.

They also require that sensitive information be kept confidential until its dissemination is appropriate. The *City Code* and the Model Code of the Stock Exchange prohibit insider trading and disciplinary action may be taken against those in breach. The old SIBs Core Conduct of Business Rules also address insider trading, but these will be superseded by the FSAs Code of Conduct which will be discussed later.

As discussed, at common law the two main grounds of insider trading liability are breach of fiduciary duty and breach of confidence.[26] The shortcomings of a cause of action under those heads of liability have already been noted. Moreover, as a general principle the common law has long since held that a person is not under a duty to disclose material information that may be in his possession by any means, to the other party to a contract.[27] Additionally, although the law of misrepresentation may provide a remedy with respect to face to face transactions, insider trading is usually conducted on the open market between anonymous traders.

As noted, even directors do not traditionally owe shareholders any duty, since their duty is to the company as a whole.[28] Only occasionally have the English courts found that directors owe a duty to shareholders. Thus only the company is in a position to seek a remedy for insider trading by directors on the basis that they may be held accountable for secret profits.[29]

Similarly, the possible remedy available for breach of confidence has not been employed nor has it received much academic attention. In theory it is relevant to insider trading

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[26] See generally, H. McVea, "Fashioning a System of Civil Penalties for Insider Dealing: Sections 61 and 62 of the Financial Services Act" (1996) July Issue Journal of Business Law 344.
[27] See *Bell & Another v. Lever Brothers Ltd & Others* [1932] A.C. 593.
[28] See *Percival v. Wright* [1902] 2 Ch 421.
[29] See *Regal (Hastings) Ltd v. Gulliver & Another* [1942] 1 All E.R. 378.

because an obligation of confidence usually exists and there is unauthorised use of information.[30]

Since the common law has not adequately catered for insider trading, various attempts have been made to enact a specific offence prohibiting the practice. In 1980, Part V of the Companies Act[31] was enacted making it a criminal offence. The relevant provisions were then re-enacted (some minor amendments were made) in the Company Securities (Insider Dealing) Act 1985[32]. This Act received criticism for being over-complicated largely because the definitions were too long and detailed. Consequently successful prosecutions under its provisions were something of a rarity.

A change in direction by the UK resulted from the European insider trading directive.[33] The Directive focuses on the nature of the inside information rather than on the fiduciary nature of the relationship. It was adopted with a view to achieving an integrated European capital market by 1992. Prior to the Directive, member states had had radically different approaches to insider trading. In some states criminal penalties were used, whereas in others, for instance Italy and Ireland, there was no specific regulation of insider trading at all.[34] The Directive was enacted in the UK via Part V of the Criminal Justice Act 1993 (CJA).[35] It remains the legislation in force today and is analysed in detail in the following section.

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[30] See F. Gurry, *Breach of Confidence* (Oxford: Clarendon Press, 1984) at 271.
[31] *Companies Act 1980* (U.K.) 1980, Part V.
[32] *Company Securities (Insider Dealing) Act 1985*, (U.K.) 1985 [hereinafter IDA].
[33] EU, *Directive 89/592 of 13 November 1989 Co-ordinating Regulations on Insider Dealing*, [1989] O.J. L. 334/30.
[34] See generally, E. Gaillard, ed., *Insider Trading: The Laws of Europe, the United States and Japan*, (The Hague: Kluwer Law and Taxation, 1992) at chapter 1.
[35] CJA, *supra* note 4, Part V.

B. Liability under Part V of the Criminal Justice Act

The CJA sets out one main offence of insider trading. Section 52 prohibits a person who has inside information as an insider from dealing in certain circumstances in securities, which are price-affected in relation to that information. There are also two related offences. The first prohibits the encouragement of another person to deal in such securities and the second prohibits disclosure of inside information.

1. Inside Information

Section 56 defines 'inside information'.[36] Subsection 1 sets out its four elements:-

> (a) it must relate to particular securities or to a particular issuer of securities or to particular issuers of securities;
>
> (b) it must be specific or precise;
>
> (c) it must not have been made public; and,
>
> (d) if it were made public would be likely to have a significant effect on the price of any securities.[37]

a) 'Particular Securities' and 'Particular Issuer(s)'

The inclusion of 'particular securities' in the definition has been widely criticised for being too broad. Theoretically it encompasses a type of security such as gilts, since gilts are 'particular securities'. It is not necessary that the gilts be any specific or already identified gilts. The fact that they are gilts as opposed to any other type of security is enough to bring them within this subsection. Thus even governmental information relating to borrowing requirements or interest rates which could have a significant effect on a certain kind of security could be inside information. More general information would not be caught, for example trade figures, as these would relate to securities generally and such information is specifically excluded.[38] Similarly the inclusion of

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[36] *Ibid* s. 56.
[37] *Ibid* s. 56(1)(I).
[38] See B. Hannigan, *Insider Dealing*, 2nd ed. (London: Longman Law, Tax and Finance, 1994) at 61-2.

'particular issuers' clearly incorporates information relating to an entire sector or industry. So, information that could affect all telecommunications operators such as a decision by OFTEL, the UK telecoms regulator, could be 'inside information'. As noted, the equivalent Canadian provision is also over-broad.

Information about a governmental policy relating to all issuers or all securities would probably be too general. In this respect the Act is narrower than the European Directive (Article 1(1)) which includes such general news[39]. According to the Directive, the information need only relate to "one or several issuers" or "one or several transferable securities. There is no requirement of "particular" securities or issuers, so any news affecting any securities falls within this element of the definition. This could pose interpretative problems for the courts as they will be bound to interpret the Act in the light of the Directive. They may have to give this section a broader interpretation than was intended by the legislature. So far, however, there have been no such challenges of the definition before the Courts.

With reference to information about a 'particular issuer' of securities, this too is expansive. According to section 60(4)[40] information about a particular issuer includes information relating to its business prospects. So if Company A invents something that will render Company B's product redundant, and this information is obtained by an insider of Company A, that insider may sell any Company B shares he may own on the basis of that information. The information relates to Company B's business prospects even though it is actually about Company A. Hannigan suggests that this "draws investment analysts further into the legislative net", as they often have information about a company's business prospects as do bankers, market makers and underwriters.[41]

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[39] EU *Directive 89/592 supra* note 33, article 1(1).
[40] CJA, *supra* note 4, s. 60(4).
[41] See *supra* note 38 at 60-61.

The previous legislation was more limited in scope since it required a transaction between two companies. [42] The information had to have been obtained as a result of that transaction in order to be caught by the act. The classic case is an impending take-over: buying shares in the target on the basis of information obtained from the predator. Such was the case in *R v. Naerger* where a former director of WH Smith, a chain of newsagents and stationers, pleaded guilty to dealing in the securities of Martin the Newsagents, a smaller chain, when he knew that WH Smiths was contemplating making a take-over bid for the company.[43] Similarly, in one of the UK's more well-publicised cases *R. v. Collier,* Collier who as head of securities at Morgan Grenfell, was advising a client and by virtue of that relationship discovered that the client company was about to bid for another company, AE. His dealings in that target company, as well as his dealings in another company under similar circumstances led to his conviction under the previous legislation.[44] The CJA is considerably broader, now that the transaction requirement has been eliminated.

b) 'Specific' or 'Precise'

The 'precise' element of the definition is taken directly from the Directive.[45] The purpose was to "leave out mere rumours and speculations" at the stock exchange since the economic function of speculation was considered to be vital.[46]

The inclusion of 'specific' derives from the previous legislation, which required that information relate to specific matters concerning the relevant company.[47] This additional element obviously broadens the scope of the Act in relation to the Directive, which in any case was only intended to set minimum standards across the Community.

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[42] IDA, *supra* note 32, s. 1(2).
[43] *R v. Naerger* unreported but see *The Guardian*, 30 April 1996.
[44] *R. v. Collier* unreported but see *Financial Times*, 2 July 1987.
[45] EU *Directive 89/592 supra* note 33, article 1(1).
[46] K. J. Hopt & E. Wymeersch, *European Insider Dealing: Law and Practice*, (London: Butterworths, 1991) at 134.
[47] IDA, *supra* note 32, s. 10(a).

With reference to the difference between the words 'specific' and 'precise', 'precise' is probably narrower than 'specific'. For example, specific information would be that a bid is going to be made whereas precise information would be the price at which a bid is going to be made. Thus 'precise' information will always be 'specific'.[48] An example of information that is always specific and precise is knowledge of an impending take-over bid.[49] Specific but imprecise information would be the knowledge of a forthcoming share placing where the details were not known[50] or the fact that a company had made substantial losses but where the magnitude of the losses was not known[51]. Similarly, knowledge of a management shake-up might be imprecise but still specific.[52]

The provision was intended to speed up disclosure, in turn reducing insider trading opportunities. Company directors are likely to be more at risk of falling foul of this provision since they have greater access to specific information. They still may trade on general information about the company however. This represents a significant advantage over other traders and will not amount to insider trading under the Act.

Some authors take the view that this section unduly inhibits the work of investment analysts. In the Scottish case H.M. *Advocate v. Mackie*[53] Mackie, an analyst, was given information by a company chairman. The case revolved around whether or not the information given to Mackie amounted to a profits warning and was therefore specific, or whether it was a vague indication of a downgrading of expectations from which Mackie calculated there would be a profits warning. Mackie was initially convicted but his conviction was quashed on appeal. The case led the government, in the debates of the

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[48] See discussion by Hannigan *supra* note 38 at 63.
[49] As in *R v. Naerger supra* note 43 and *R. v. Collier supra* note 44.
[50] Such was the case in *R. v. Cross* [1991] BCLC 125 at 132, CA.
[51] As in *R v. Goodman* unreported but see *Financial Times*, 1 May 1991; and 16 June 1992.
[52] As in *R v. Jenkins*, unreported but see *Financial Times*, 18 July 1987.
[53] *HM Advocate v. Mackie*, unreported but see *Financial Times*, 30, 31 March 1993, and 18 February 1994.

Criminal Justice Bill, to state that it did not wish to inhibit the relationships of companies and fund managers.[54]

The reason for protecting analysts is that it is considered that a certain amount of disclosure by companies prior to an announcement can be beneficial to both the market and to the company since the gradual release of the information into the market softens its 'blow'. This is of course one of Manne's main arguments in favour of insider trading. The obvious drawback is however that there is a selection process involved. Only certain privileged parts of the market may receive the information (i.e. the clients of the analyst). This goes against the spirit of the legislation, which aims to create a level playing field.

c) Not 'Made Public'

Although initially reluctant to provide a definition of 'made public' fearing that it would undermine the effectiveness of the legislation, the government eventually bowed to pressure from the City.[55] The previous legislation had been unclear on this point since it required information to be "not generally known to those persons who are accustomed or would be likely to deal in those securities".[56] It was felt by many that this was unsatisfactory given that insider trading was a criminal offence. The lack of clarity has only been partially resolved by section 58 since it is divided into two parts, the first defining information which is 'deemed' to have been made public, and the second defining information which 'may be treated' as made public.

(1) Information Which is 'Made Public'

Information is made public if:

(a) it is published in accordance with the rules of a regulated market, or

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[54] U.K., H.C., Parliamentary Debates, session 1992-3, Standing Committee B, at col. 177 (10 June 1993).
[55] CJA, *supra* note 4, s.58.
[56] IDA, *supra* note 32, s. 10.

(b) it appears in any records which, by virtue of any enactment, are open to inspection by the public.[57]

This means that as long as information is published in accordance with the Stock Exchange rules, it will be deemed to be public, even if in fact the market has not assimilated the information. Therefore it is possible to deal immediately after the release of the information, or as soon as it appears in any public document. Under the old legislation it was necessary to wait until the information was 'generally known' (when the price had adjusted to the information). That position reflected the U.S. position which requires that information be 'effectively disclosed' in a manner 'sufficient to insure its availability to the investing public'.[58] The new law has been criticised since it now effectively offers the insider dealer a loophole.

Information is also made public if it can be readily acquired by those likely to deal in any securities to which the information relates. Similarly it is made public if it is derived from information which has been made public. The object of this is clearly to protect analysts, who are potentially at risk in several ways. They may invest time and energy in the analysis of publicly available data and through their efforts discover some price sensitive information on the basis of which they may wish to deal on their own account. In this case, as long as the publicly available data was not too obscure then the analyst should be free to trade. On that point it is worth noting that a Law Society memorandum suggested that a better wording would be "made available to the public" as opposed to "made public" which would have given analysts more leeway to use obscure publications as sources.[59] The wording "made public" however is taken directly from the Directive, which is probably sensible since problems of interpretation will be reduced.

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[57] CJA, *supra* note 4, s.58(2).
[58] *SEC v Texas Gulf Sulphur Company*, 401 F.2d 833 (2d Cir. 1968).
[59] The Law Society Company Law Committee, "The Law on Insider Dealing", December 1992 Memorandum No 281, at paragraph 8.4.

The situation differs slightly when research is done with a view to publication that will in turn affect the company's share price. Hannigan takes the view that the analyst may trade on his own account before publication, but a colleague with access to this information could not.[60] The fact that there is to be a recommendation by the analyst amounts in itself to inside information if it may affect the price of securities.[61]

(2) Information Which 'May be Treated as Made Public'

This subsection has been criticised since it offers only a non-exhaustive list of situations which is fairly unhelpful.[62] Hannigan suggests that it would have been preferable to shift the burden of proof so that the insider dealer had to show that the information was in fact in the public domain.[63]

Under section 58(3) information may be treated as having been made public even though:

(a) it can be acquired only by persons exercising diligence or expertise;

(b) it is communicated to a section of the public and not to the public at large;

(c) it can be acquired only through observation;

(d) it is communicated only on payment of a fee; or it is published only outside the United Kingdom.

The 'diligence and expertise' concept may allow trading on the basis of information gleaned from an obscure journal. The 'section of the public' could be a special market information service depending on its scope. 'Observation' could be seeing a factory chimney smoking at night, from which it could be deduced that the factory is working

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[60] See *supra* note 38 at 69.
[61] The UK differs from the U.S. significantly in this respect. Note the result in the Foster Winans case discussed in Chapter Two: *United States v Winans*, 612 F. Supp. 827 (1985) affirmed in relevant part *sub nom U.S. v Carpenter*, 791 F2d 1024 (2d Cir. 1986).
[62] CJA, *supra* note 4, s.58(3).
[63] See *supra* note 38 at 72-3.

overtime. However, the fact that a factory is working overtime does not convey anything specific or precise, therefore the utility of this is questionable.[64]

Similarly, 'payment of a fee' offers nothing conclusive. The fee may or may not be sufficient to make the information public. It will all depend, one assumes, on the scope of the information service. Again, publication 'outside of the UK' is not particularly helpful since it will really depend on how widely the publication is read and how easily available the publication is.

The main problem with this part of the subsection is that an offender will not know until a court decides that information was not made public. Thus he will not necessarily know at the time he committed the offence that it was in fact an offence. This obviously goes against the fundamental principle of non-retroactivity in the criminal law.

(3) 'Significant Effect' on the Price of any Securities

Section 56(2) sets out that "securities are 'price-affected securities' in relation to inside information, and inside information is 'price-sensitive information' in relation to securities, if and only if the information would, if made public, be likely to have a significant effect on the price of the securities".[65] Most authors are in agreement with Rider and Ashe that this is the "most essential feature of the statutory definition" since it will be "the determining factor when a jury considers whether information is inside information".[66]

The previous act required that the information, if generally known, would be likely to materially affect the price of the securities.[67] The new wording ("significant effect") is taken from the Directive, which offers no further help as to what 'significant' should

[64] See *ibid* at 71.
[65] CJA, *supra* note 4, s.56(2).
[66] See Rider *supra* note 22 at 37.
[67] IDA, *supra* note 32, s. 10(b).

amount to.[68] Hopt thought it would be advisable for member states to specify in their implementing laws the meaning of 'significant', however Britain has chosen not to do so.[69] This is unsurprising since it would probably be impossible to compose a definition: a significant price change for one type of security will not necessarily be significant for another.

Furthermore, there may be several factors which may account for a price movement, the release of that piece of information being only one of them. Rider and Ashe suggest that the only solution is for the courts to use a "reasonable investor" test relative to the securities in question and "leave the matter to the jury". They cite a Singaporean case that established that information is price sensitive if it is information that would influence the ordinary reasonable investor to buy or sell the security in question.[70] They also note the American case *TSC Industries* discussed *supra,* which has been adopted by the Canadian courts, which used a more complicated test requiring a 'substantial likelihood' that the disclosure of the fact would have been viewed by the investor as having 'significantly altered the total mix' of information made available.[71] However they conclude, "such approaches do not really help" since, except in obvious cases, careful analysis of the evidence must be the only way to decide what is a "significant effect" on price.[72] This is probably true, but of course whereas the prosecutor will have the benefit of hindsight when deciding whether a price movement was significant, the insider dealer will not. He can only take the risk and hope, ironically, that he does not make too much money so as to stimulate the interest of those responsible for the surveillance of the Stock Exchange.

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[68] EU *Directive 89/ supra* note 33, article 1(1).
[69] See *supra* note 46 at 135.
[70] *Public Prosecutor v Allan Ng Poh Meng* [1990] 1 MLJ v (Singapore). Discussed by Rider *supra* note 22 at 37.
[71] *TSC Industries v Northway* 426 U.S. 438 (1976). Discussed Discussed by Rider *supra* note 22 at 37.
[72] See Rider *supra* note 22 at 38.

The inclusion of the provision however seems sensible, since it should offer some kind of *de minimis* threshold. The government hoped that it would bring the focus of the law to "major matters such as impending take-over bids, forthcoming profits and dividend announcements which are out of line with expectations".[73] If the insider trading laws were used to control more trivial breaches this would not reflect the policy behind the legislation, since they would not have an effect upon the integrity of the market. Furthermore, it ensures that communication between companies and analysts is not unduly hindered.

2. *The Insider*

An individual is only guilty of insider trading if he has information 'as an insider'.[74] According to section 57 (1) a person only has information as an insider if, and only if,

> (a) it is, and he knows that it is, inside information; and
>
> (b) he has it, and knows that he has it, from an inside source.[75]

Subsection (2) states that a person has information from an inside source if, and only if,

> (a) he has it through
>
> (i) being a director, employee or shareholder of an issuer of securities ; or
>
> (ii) having access to the information by virtue of his employment, office or profession; or
>
> (b) the direct or indirect source of his information is a person within paragraph (a).[76]

The previous legislation required that an insider be connected to the issuer or a related company in some way, as a director, an officer or because he was engaged in a position

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[73] Parliamentary Debates *supra* note 54, session 1992-3, Standing Committee B, at col. 177 (10 June 1993).
[74] CJA, *supra* note 4, s.52(1).
[75] *Ibid* s.57(1).
[76] *Ibid* s.57(2).

or professional relationship whereby he might reasonably be expected to have access to information.[77] The wording used in the CJA is taken directly from the Directive, which does not require a 'connection'. Rather, liability is based upon whether or not the insider has an informational advantage, thus his status is irrelevant.[78]

a) Primary Insiders

(1) Directors

Considered to be the 'classic insiders', directors were the first to be the targets of insider trading legislation as noted earlier. The nature of their position means that they will inevitably come into contact with inside information. They are specifically listed as insiders in the Act.[79] Importantly they must have obtained the information through being a director; if they come across the information in some other way they will not be liable (unless under the tippee provision).

There is no definition of 'director'. It is likely that the term covers non-executive directors as well as executive directors, but, since there is no mention of 'shadow' directors these probably are not included. Equally though, they are not excluded so the courts may choose to interpret the word widely and include them. In any case, they would probably fall foul of the tippee provision, so this could be used as an alternative basis of liability.

(2) Employees of an Issuer

The position of employees was rather more complicated under the previous legislation since the emphasis was not on whether or not they had in fact had access to inside information. Instead, the prosecution had first to establish that the position that they held was one which 'may reasonably be expected to give him access to information'. Secondly, they had to show that it would be 'reasonable to expect a person in his position

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[77] IDA, *supra* note 32, s. 1.
[78] See Rider *supra* note 22 at 41.
[79] CJA, *supra* note 4, s.57(2)(a)(i).

not to disclose except for the proper performance of his functions.[80] This represented quite a hurdle for the prosecution who might struggle to show that, for example, a secretary was in such a position.[81] Now it is only necessary to show that the employee obtained the information through being an employee, which means that all employees are potentially primary insiders, even junior employees.

(3) Shareholders

Most anti-insider trading regulations (including the US) include shareholders with a certain percentage holding (often 10% and upwards) in the primary insider category,[82] however, prior to the Directive the United Kingdom did not (unless they were tippees). Now in conformity with the Directive[83], the CJA lists shareholders along with directors and employees.[84] There is no threshold in terms of percentage shareholding. Although shareholders with a larger holding are more likely to have access to inside information, should a smaller shareholder come into contact with such information by virtue of his holding there is no logical reason why he should not be subject to the insider trading restrictions. Ethically it amounts to the same thing. Again, shareholders will only be caught by the legislation if they obtain the inside information through being a shareholder.

(4) Those With Access to the Information by Virtue of their Employment, Office or Profession

This is a wide sweeping category: any person who has access to information by virtue of the exercise of their employment, profession or duties is now a primary insider.[85] The Directive does not limit this category by listing such positions exhaustively, or by specifying a level of salary or seniority, or as the UK did before, by limiting it to jobs whereby contact with inside information was habitual.[86] Now anyone with access to

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[80] IDA, *supra* note 32, s. 9(b).
[81] For example *R v Jenkins supra* note 52.
[82] See *supra* note 46 at 136.
[83] EU *Directive 89/592 supra* note 33, article 2.
[84] CJA, *supra* note 4, s.57(2)(a)(i).
[85] CJA, *supra* note 4, s.57(2)(a)(ii).
[86] See *supra* note 46 at 137.

inside information because of his employment is potentially a primary insider. There is no need for them to be connected with the issuer in any way. This means that a broad spectrum of people will be covered, from printers to analysts.

(5) Professional Advisors

These have been called 'temporary insiders' (a term coined as noted earlier in the U.S. cases) and 'peripheral insiders'. They comprise lawyers, bankers, brokers and public relations advisers amongst other professionals who advise an issuer. They have always been potentially at risk in the United Kingdom if they occupied a position that habitually gave them access to information. However, some cases were less clear under the previous Act.[87] For example, a junior in a law firm who overhears information but whom would not normally be privy to such information. Such a person might qualify as a tippee, but if another junior overheard the first junior discussing the information the position of liability previously would have been more tenuous. Now, obtaining the information by virtue of one's employment is enough to qualify as a primary insider. It is a simpler approach and makes prosecution a little more straightforward.

(6) Investment Analysts

Since investment analysts were not connected to the company they were not primary insiders under the previous Act. There has been much debate about their inclusion now under the CJA since there is a fear that their communications with companies will become unduly constrained. The government was clear that it did not wish to hinder good communications between analysts and companies but did warn against companies 'selectively' disclosing information.[88] Hannigan points out though, that analysts were already at risk under the tippee provision before, since they would have obtained their information from primary insiders specifically directors, so in fact there is not a great change in the law in this respect.[89]

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[87] IDA, *supra* note 32, s. 9(b).
[88] Parliamentary Debates *supra* note 54 at col. 198.
[89] See Hannigan *supra* note 38 at 84.

(7) Public Servants

Since anyone with access to information by virtue of their office will be subject to the legislation, a wider section of public servants will now be covered. The previous Act enumerated the offices to which the law would apply, leaving scope for extension only by means of an order of the Secretary of State who could declare a person or persons to be a 'public servant'.[90] The new wording avoids the need for enumeration, and consequently the ambit is widened to include officers and employees of the take-over panel and of the various regulatory bodies such as OFTEL.

(8) Printers and Journalists

After the famous Winans case[91], in the U.S. there has been much energy devoted by academics to the discussion of journalists and their vulnerability to conviction for insider trading. As discussed earlier, Winans wrote a column in the *Wall Street Journal* in which he would make predictions and trading recommendations about company securities based on his own analysis rather than on any inside information about the companies. It was well known that a recommendation in his column could raise a share price. Winans was convicted of insider trading because he gave some individuals information about the contents of his column in advance of its publication. The conviction was based largely on the fact that the prosecution were able to establish that the contents of his column were the property of the *Wall Street Journal* so he had in effect taken confidential information from the newspaper.

The policy behind the latter conviction was that the insiders had an informational advantage over the rest of the market. Since this is also the basis of the CJA it has been argued that Winans would now face conviction in the United Kingdom too, and this has been one of the criticisms of the Act. Arguably since Winans merely revealed the fruits of his own intelligence he should not have been convicted of insider trading. Under the

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[90] IDA, *supra* note 32, s. 2(4) and (5).
[91] *United States v Winans, supra* note 61.

previous legislation he certainly would not have been since he had no connection to the companies about which he wrote.[92]

The debate would now be whether or not he had 'access to information' by virtue of his position. Some have argued that he would have, whereas others believe that a court could not find that he had access to information which he generated himself through his employment.[93] One hopes that the latter is true, since a conviction seems to be inappropriate in this case. Rather, the Wall Street Journal should have been left to discipline its journalist had it felt it to be necessary. An insider trading conviction does not seem to be a valid use of the criminal law on the facts.

(9) Cleaners, Postmen, Printers etc.

Office cleaners, printers and anyone else coming across information whilst at work could be considered as having access to information by virtue of their employment. Rider and Ashe though do not think that such people will be greatly at risk from prosecution unless it is their function to have access to the information; an office window cleaner therefore would not fall into this category. Printers, though should take care not to breach the rules since, by the very nature of their job, they will have access to information by virtue of their employment.

b) Secondary Insiders (Tippees)

A person has information as an insider if the information is, and he knows that it is, inside information, and he has that information, and knows that he has the information from an inside source. A person has information if the direct or indirect source of his information is an 'insider'. As discussed this is a person who has information through being a director, employee or shareholder of an issuer, or by virtue of his employment office or profession.[94]

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[92] IDA, *supra* note 32, s. 9.
[93] See Rider *supra* note 22 at 42
[94] CJA, *supra* note 4, s.57(2)(a).

The key to the liability of a 'tippee' is that he has the requisite knowledge. He must know that the information is inside information and that it comes from an inside source. Merely acting on a tip to 'buy X ltd' would not render him liable since no inside information has been imparted.[95] It would be particularly difficult to establish his liability when the information has passed through several hands. This does not reflect the position in the U.S. where the tippee cannot receive suspicious information and rely on his lack of enquiry to escape liability. [96]

However, the provision is broader under the CJA than it was under the previous legislation. This required that inside information be 'obtained' by the tippee[97] which led to dispute over the meaning of the word.[98] Now it is only necessary that the source be an insider: the fact that the tippee may have been a passive recipient of the information is irrelevant. It is not even required that the tippee know the identity of the insider as long as he knows that the information came from an insider.

Despite this Hannigan points out that it will still be difficult to prove that the source of the information was an insider. Even if there is substantial circumstantial evidence such as trading prior to a take-over and family links with the relevant company, it will still have to be shown that the information came from an inside source. If both parties deny their involvement this will be impossible to establish.[99]

3. *The Offences*

There are three offences under the CJA, namely the main dealing offence, and the two offences of encouraging and disclosing.

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[95] The person giving the tip will be guilty of the encouraging offence. [95] CJA, *supra* note 4, s. 52(2).
[96] See Rider *supra* note 22 at 45.
[97] IDA, *supra* note 32, s.1(3)(a).
[98] See Hannigan *supra* note 38 at 86-87.
[99] *Ibid* at 88.

a) The Dealing Offence

There are three elements to the offence:

1. an individual must have information as an insider;

2. he must deal in securities that are price-affected in relation to the information, and,

3. he must either be a professional intermediary, or he must make an acquisition or disposal of the securities using a professional intermediary or via a regulated market.[100]

(1) The Source of the Information Must be an Insider

This has already been discussed *supra.*

(2) The Insider Must Deal in Securities that are Price-affected in Relation to the Information

(a) 'PRICE-AFFECTED'

A person may not deal or procure a deal in securities that are 'price-affected' in relation to the information that he holds as an insider.[101] 'Price-affected' means that the price of the securities would be significantly affected if the information were to be made public.[102] That means that the information need not necessarily relate to the insider's company, or even to a transaction that involves the insider's company. The test is simply that the price of the securities would be affected by the information if it were to be made public.

(b) 'DEALING'

Dealing in securities for the purposes of the Act is either,

(a) acquiring or disposing of securities either as a principal or an agent, or,

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[100] CJA, *supra* note 4, s. 52(1).
[101] *Ibid* s. 52(1).
[102] *Ibid* s. 56(2).

(b) procuring, directly or indirectly, an acquisition or disposal of securities by any other person.[103]

(I) ACQUIRING AND DISPOSING

'Acquiring' a security includes agreeing to acquire a security and entering into a contract which creates a security.[104] Similarly, 'disposing' of a security includes agreeing to dispose of a security and also bringing to an end a contract which created the security.[105] The definition includes therefore, situations whereby a dealer does not acquire the legal title to a security, for example, where he has bought and sold on the same account without taking the legal title to the security. It also includes derivatives since there is no existing security to be acquired or disposed of: entering the contract has the effect of creating a new security (for example, options, index contracts and other contracts for differences).[106]

(II) PRINCIPAL OR AGENT

Since a person deals in securities if he deals as principal or agent, this means that both parties can be liable (for instance, an employee and the firm for which he works).

(c) SECURITIES

The Act applies to the list of securities contained in Schedule 2.[107] That list may be amended by order of the Treasury.[108] The list comprises "shares", meaning shares and stock in the share capital of a company; "debt securities" issued by a company or a public sector body; "warrants", meaning any right to subscribe for shares or debt securities; "depository receipts", meaning any record issued by a person who holds securities which acknowledges that another person is entitled to rights in relation to those securities; "options", meaning any right to acquire a relevant security; "futures", meaning rights

[103] *Ibid* s. 55(1)(a) and (b).
[104] *Ibid* s. 55(2)(a) and (b).
[105] *Ibid* s. 55(3)(a) and (b).
[106] See further Hannigan *supra* note 38 at 92.
[107] CJA, *supra* note 4, Schedule 2.
[108] *Ibid* s. 54.

under a contract for the acquisition or disposal of relevant securities at a future date but at a price fixed at contract date, and finally "contracts for differences" meaning rights under a contract which does not provide for the delivery of securities but whose purported purpose is to secure a profit or avoid a loss by reference to fluctuations in a share index, the price of particular relevant securities, or the interest rate offered on money placed on deposit.[109]

The Act applies to the above list of securities only in so far as they comply with the conditions set out in an Order by the Treasury.[110] These essentially limit the scope of the Act to securities that can be traded on a market. Such securities must either be listed in a State within the European Economic Area, or, admitted to dealing or quoted on a "regulated market". A "regulated market" is a market that is established under the rules of an investment exchange listed in the Schedule to the Order.

(d) PROCURING

A person is also liable if he procures the acquisition or disposal of a relevant security. 'Procuring' includes buying a security by means of an agent, nominee, or through a person acting at the procurer's direction.[111] These are examples and do not represent an exhaustive list.[112] This means that when an insider uses an innocent third party to procure his deals, although the third party will not be liable because he lacked the requisite knowledge, the insider will be liable for procuring. Evidently, without such a provision insiders would have an easy way round the legislation.

An interesting situation arises in the case of discretionary fund managers. Here a person hands over funds to the manager giving him discretion to invest it where he thinks appropriate. A problem arises if the manager invests the funds in securities about which

[109] *Ibid* Schedule 2, paras. 1-7.
[110] These appear in the *Insider Dealing (Securities and Regulated Markets) Order* (U.K.) Statutory Instrument No.187 (1994).
[111] CJA, *supra* note 4, s. 55(4).

the investor has price-sensitive information. Assuming that there was no communication between the investor and his manager, the investor would have a defence that he would have dealt anyway (discussed post). Furthermore, the Economic Secretary stated in the parliamentary debates discussing the Bill that where an investor gives a manager a general discretion to manage his affairs, he could not be taken to have directed the investment and thus procured the acquisition of the securities.[113] The manager would not have committed an offence because he never had the inside information. There is no positive duty on the investor to tell the manager which securities he may not invest in.

(3) Dealing on a Regulated Market or Acting as or Relying on a Professional Intermediary

The offence requires that the acquisition, or disposal, takes place on a regulated market, or, that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.[114]

(a) REGULATED MARKET

This means any market, however operated, which, by an order made by the Treasury, is identified (whether by name or by reference to criteria prescribed by the order) as a regulated market.[115]

(b) PROFESSIONAL INTERMEDIARY

"Professional intermediary" is defined in section 59 of the Act. It is a person (1) who carries on a business consisting of an activity whereby he acquires or disposes of securities (as principal or agent) or acts as an intermediary between persons who are dealing in securities, or, (2) a person who is employed by such a person described in the above category.[116]

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[112] *Ibid* s. 55(5).
[113] Parliamentary Debates *supra* note 54 at cols. 171-172 (the Economic Secretary).
[114] CJA, *supra* note 4, s. 52(1) and (3).
[115] *Ibid* s. 60(1).
[116] *Ibid* s. 59(1) and (2).

Furthermore, a professional intermediary must hold himself out to the public or a section of the public as willing to engage in the above business.[117] A person is excluded from the definition if the conduct of such activity is merely incidental to another activity not covered by the Act, or if such activity is conducted only occasionally. A person only relies on a professional intermediary if the professional intermediary carries out the activity in relation to his deal.[118]

The definition means that private transactions, such as an off-market deal between private clients, will be caught by the act if they are conducted through a professional intermediary. If the two private clients dealt face to face they would not be committing an offence.[119]

b) The 'Encouragement' Offence

An individual who has information as an insider must not encourage another person to deal in securities that are price-affected in relation to that information, if he knows, or has reasonable cause to believe, that the dealing would take place on a regulated market or through a professional intermediary.[120] The offence is committed simply by recommending to another that someone purchase the securities even if no information is actually divulged. On the other hand, there is no offence if the deal takes place face to face.

c) The 'Disclosure' Offence

Similarly, an individual who has information as an insider must not disclose information that he has an insider, otherwise than in the proper performance of the functions of his employment, office or profession, to another person.[121] Consequently Dirks[122] (the employee who disclosed the fraud taking place in his company) would be liable in the U.K. under this section.

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[117] *Ibid* s. 59(1)(a).
[118] *Ibid* s. 59(4).
[119] See further Hannigan *supra* note 38 at pp. 100-101.
[120] CJA, *supra* note 4, s. 52(2)(a) and s. 52(3).
[121] *Ibid* s. 52(2)(b).

4. *Defences*

Several defences are available under the Act. There are three defences to the dealing and encouragement offences. First, an individual is not guilty if he can show that he did not expect the dealing to result in a profit attributable to the inside information.[123] Secondly, he is not guilty if he can show that he believed that the inside information had been disclosed widely enough, to ensure that no person taking part in the dealing would be prejudiced.[124] Third, he is not guilty of he can show that he would have dealt without the information.[125]

There are two defences to the disclosure offence. The first one is that the insider did not expect any person to deal in the securities because of the disclosure.[126] The second is that, although he expected dealing to take place, he did not expect it to result in a profit attributable to the inside information.[127]

5. *Sanctions*

Under the CJA, the maximum penalty is seven years imprisonment or an unlimited fine or both.[128] The Government chose to use criminal penalties as the main sanction in order to convey the 'seriousness with which it viewed' insider trading. This was despite calls for a change in approach in 1990.[129] The absence of civil remedies in the act was criticised by many since the reality is that courts have been reluctant to impose custodial sentences. Those that are imposed are usually suspended. Furthermore, fines under the Act have not been very severe, sometimes being less than the profit made by the insider trader.[130]

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[122] *Dirks v. SEC*, 445 U.S. 646 (1983).
[123] CJA, *supra* note 4, s. 53(1)(a) and s. 53(2)(a).
[124] *Ibid* s. 53(1)(b) and s. 53(2)(b).
[125] *Ibid* s. 53(1)(c) and s. 53(2)(c).
[126] *Ibid* s. 53(3)(1).
[127] *Ibid* s. 53(3)(2).
[128] *Ibid* s. 61(1).
[129] See Hannigan *supra* note 38 at 117.
[130] See *ibid* at 118-127.

As noted earlier, criminal prosecution powers rest currently with three authorities: the Secretary of State for Trade and Industry, the Crown Prosecution Service, and the Serious Fraud Office.[131] Under the FSMA, the FSA will also be able to prosecute under the Part V of the CJA in England and Wales.[132]

C. Liability under the FSA's Draft Code of Market Conduct

As noted earlier, the FSMA empowers the FSA to make rules. So far, it has published a Draft Code of Market Conduct (the "Code"), which it has drawn up in consultation with market practitioners, investment exchanges and 'other interested groups'.[133] It is worth noting that the FSA has the power to alter or replace the Code at any time.[134] Breach of the Code will result in the imposition of sanctions, which are discussed later. Additionally a breach will be evidence of a 'breach of statutory precepts', whereas compliance will be admissible as evidence that a person has not breached statutory precepts.[135]

1. The Prohibitions

a) Dealing

The essence of the prohibition in relation to insider trading is that a person must not misuse privileged information. Thus, a person who is in 'privileged possession' of 'relevant information' that is 'disclosable information' should not deal in any investment to which the information is relevant.[136]

b) The Information

In order to fall foul of the Code, a person must misuse information that is both 'relevant' and 'disclosable'.

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[131] In Northern Ireland, the responsibility for prosecutions rests with the Director of Public Prosecutions, and with the Crown Office in Scotland. See CJA, *supra* note 4, s. 61(2).
[132] FSMA *supra* note 2 Part XXVII s. 402.
[133] Financial Services Authority, *Consultation Paper 10 supra* note 18 at 3.
[134] FSMA *supra* note 2 Part V s.119(4).
[135] Financial Services Authority, *Consultation Paper 10 supra* note 18 at 3.
[136] *Ibid* at 12.

(1) 'Relevant Information'

Relevant information is basically price-sensitive information. It is

> ...any information which persons in a market would reasonably regard as significant in determining whether to deal in an investment traded on that market.[137]

The test is an objective one to be judged from the standpoint of the 'reasonable market user' in that market.[138] The test, like any other price-sensitive test, is obviously easier to use after the event when it will be evident whether or not the information had any impact on the price of the investments.

(2) 'Disclosable Information'

This element of the definition appears to cut down the scope of the Code. However, the definition is wide, encompassing far more than the statutory company disclosure requirements. Disclosable information is any information:

> the substance of which is required to be disseminated (either immediately or subject only to the passage of time) on or in relation to a designated market, or
>
> the substance of which concerns impending developments or matters in the course of negotiation which, if they came to fruition, would be required to be disseminated on or in relation to a designated market, or
>
> which is the subject of an official announcement by governments, central or fiscal authorities, or regulatory authorities.[139]

Thus, it is information, which is disclosable because of a legal obligation,[140] or under market or regulatory obligations, including continuing disclosure obligations (for listed companies), and also any reporting obligations required by stock exchanges. It also

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[137] *Ibid* at 6.
[138] *Ibid* at 20.
[139] *Ibid* at 7.
[140] Such as under the *Companies Act 1985 supra* note 23.

catches any negotiations or impending developments that ultimately could lead to an obligation to disclose.[141]

(3) Privileged Possession

A person can only make unfair use of information if he is in 'privileged possession' of it. A person's possession of information is privileged for so long as

> ... he knows or ought to know that other market users cannot legitimately obtain that information. [142]

The FSA gives examples of when this might occur:

> Commonly a person will have privileged possession because of a special relationship he has with the source, or it may be because he has obtained the information by reason of a disclosure that not ought to have been made or was made mistakenly.[143]

Whether or not a person ought to know that other market users cannot legitimately obtain the information will be judged "against the general knowledge, skill and experience expected of a person in his office, employment or position"[144].

The test is an interesting one. It takes a fresh approach since it does not focus on how the information is obtained, whether that be because the insider had access to information or otherwise. The emphasis instead is on legitimacy. This means that analysts will not be hindered in their research. They need not speculate about whether or not information has been effectively disclosed if it is published only in the Tonga Evening News and not the Wall Street Journal. They can rest assured that, as long as they come by the information legitimately, their diligence may be rewarded. The scope of this test is not as wide as under the CJA, but it is wide enough. In any case, its simplicity, in an area of law that has become overcomplicated, is to be commended.

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[141] Financial Services Authority, *Consultation Paper 10 supra* note 18 at 19.
[142] *Ibid* at 12.
[143] *Ibid.*
[144] *Ibid.*

c) *Tipping*

Where a person has privileged possession of relevant information that is disclosable information, he should not do any act, nor engage in any course of conduct, which might reasonably be considered as likely to encourage or induce any other person to deal in investments to which the information is relevant.[145]

There is no separate prohibition of disclosing information. Instead disclosing relevant information will 'commonly constitute encouragement'. Whether or not a person's actions might be considered likely to encourage or induce others to deal will be considered in the light of all the circumstances, however. This will include accepted market practices and the expertise of the persons concerned. Given this, proper legitimate disclosure should not fall foul of the Code.[146]

2. *Defences*

First, a person will not be in breach of the Code if, in the context of a take-over situation, he is the offeror, and he uses the information for the purpose of pursuing the bid by buying an equity stake in the target.[147]

Secondly, the use of 'order-flow' information (information relating to any person's intention to deal in investments) is not restricted, except in the case of a take-over. Thus 'front-running' a customer is not prohibited under the Code (although it may be prohibited under other rules).[148]

Thirdly, a person will not be in breach of the Code if he can show that his possession of the information did not in any way influence him in determining whether to deal. This covers situations whereby a person is under a pre-existing obligation to deal.[149]

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[145] *Ibid* at 13.
[146] *Ibid.*
[147] *Ibid.*
[148] *Ibid* at 13-14.
[149] *Ibid* at 14.

3. *Sanctions*

The FSMA contains a wide range of enforcement powers that will be available to the FSA. In addition to investigation powers,[150] the FSA will have the power to bring criminal proceedings in respect of some offences, of which insider trading is one.[151] Furthermore, section 123 of the Act gives the FSA the power to impose penalties in cases of 'market abuse'.[152]

With reference to criminal proceedings, the FSA will be able to institute criminal proceedings for violations of Part V CJA in addition to the current authorities.[153] The administrative penalty would generally be an alternative option to criminal proceedings for the FSA. When deciding which route to take the FSA will consider two issues. First, whether there is sufficient evidence to provide a realistic prospect of conviction (the 'evidential test'). Secondly, whether having regard to the seriousness of the offence and all the circumstances, criminal prosecution is in the public interest (the 'public interest test'). If the FSA decides that criminal prosecution is appropriate, it will either prosecute the offender itself, or it will refer the case to another authority. [154]

Although generally the civil and criminal routes are to be alternatives, the FSA has reserved the right to bring civil action in addition to criminal prosecution:

> An allegation of market abuse is different from an allegation that the criminal law has been breached. However, we recognise that fairness to the person concerned requires very careful consideration before seeking to impose a civil fine for conduct that is, or has already been, the subject of a criminal trial.[155]

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[150] FSMA *supra* note 2 Part XI s. 168.
[151] FSMA *ibid* Part XXVII s. 402.
[152] FSMA *ibid* Part VII s.123.
[153] FSMA *ibid* Part XXVII s. 402.
[154] Financial Services Authority, *Consultation Paper 10 supra* note 18 at 49.
[155] *Ibid.*

The general policy, it seems, will be not to impose a civil fine in cases where there has been a criminal prosecution on the same facts.[156] However, this is only a general statement of policy. Clearly the FSA believes that there may be exceptions to this general rule. One such exception might be to secure restitution for 'victims'.[157]

Under the FSMA the FSA will be empowered to apply to the courts for injunctions to prevent threatened or continuing market abuse[158], or to restrain threatened or continuing breaches of the criminal law[159].

With reference to administrative fines, the FSA will have the power to impose fines of 'such amount as it considers appropriate'.[160] There has been no guidance as to the levels intended to be levied, other than some general principles. Two issues will guide the FSA, first, the need to provide an adequate disincentive to future abuse and second, the person concerned should pay the FSA's costs.[161]

The Act also empowers the FSA to apply to the courts for restitution orders for market abuse.[162] This would be in the form of disgorgement of profits and compensation. Contemporaneous traders however, will not be as fortunate as they are in the US. The FSA takes the view that to award contemporaneous traders compensation in insider trading cases would be to grant them an unjustified windfall. Additionally, companies that have been the subject of insider trading, or information misuse, will not be entitled to recover. This is because the FSA firmly rejects the misappropriation theory.[163] The policy of the regulation is quite different to that of the United States:

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156 *Ibid.*
157 *Ibid.*
158 FSMA *supra* note 2 Part XXV s.383.
159 FSMA *ibid* Part XXV s.382.
160 FSMA *ibid* Part VIII s. 123. See also Financial Services Authority, *Consultation Paper 10 supra* note 18 at 51.
161 Financial Services Authority, *Consultation Paper 10 ibid* at 55.
162 *Ibid* at 57.
163 *Ibid* at 58.

> ... the rationale for the proposed market abuse regime in the UK is very different: it is directed at protecting the integrity of market mechanisms, rather than protecting the interests of any particular group of market users.[164]

In situations where information has been misused, an action will in any case be available for breach of confidence.

4. *A Breach of Human Rights?*

Given the wide-ranging powers to make up its own rules, and to impose unlimited monetary sanctions for breach of them, it is unsurprising that the FSA's discretion has been called into question.[165] It has been suggested that the proposals could contravene the European Convention on Human Rights (the ECHR).[166] Article 6 of the ECHR grants everyone to a fair and public hearing before an independent and impartial tribunal. The FSA is hardly that.[167]

The response by the Government has been interesting. Admirably, an independent tribunal will be established (the Financial Services Tribunal) which will comply with the ECHR. Its role will be to act as an appellate body, which will rehear cases *ab initio*. However, despite this, the attitude of the Government has been to deny that there is any breach of the Convention. The standpoint taken is that the sanctions imposed are not of a criminal nature:

> ... the fact that a fine is imposed does not in itself lead to a conclusion that the proceedings are criminal. Nor does the power to award high financial penalties (which in itself is vital if the objective of protecting the public is to be realised) in itself make the provisions criminal in nature, given their essentially

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[164] *Ibid* at 57-58.
[165] See "UK's New Financial Regulator Takes Shape" (1999), http://www.lawmoney.com/public/contents/publications/IFLR/iflr9810/2.html (date accessed: 1 August 1999) at paras. 14-16.
[166] *European Convention for the Protection of Human Rights and Fundamental Freedoms* (November 4, 1950) 213 U.N.T.S. 221, U.K.T.S. 71 (1953) [hereinafter ECHR].
[167] ECHR *ibid* art. 6.

> disciplinary character. It is relevant in this context that there is no provision for imprisonment in default of payment of a fine, which is on the contrary recoverable as a civil debt under the draft Bill.[168]

The government is keen to show that the sanctions are not criminal because if they were they might amount to retrospective criminalisation. Article 7(1) of the ECHR prohibits this, which means that offences must be clearly defined in law so that an individual may foresee the legal consequences of his actions.[169] Since the rules in the Draft Code are vague, and the monetary penalties are of unspecified amounts, there is a risk that if deemed to be of a criminal nature they would fall foul of the ECHR. It remains to be seen whether or not they will be challenged in the courts.

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[168] "Financial Services and Markets Bill: Memorandum from HM Treasury to the Joint Committee on Parts V, VI and XII of the Bill in relation to the ECHR" (1999), http://www.hm-treasury.gov.uk/docs/1999/fsmbmemo175.html (date accessed: 1 August 1999) at para.11.
[169] ECHR *supra* note 166 art. 7(1).

CONCLUSION

Insider trading is an offence of a special nature. Regardless of sophisticated methods of detection, at the end of the day, enforcement agencies will often be left with little more than proof of fortuitous trades and a suspicion that a trader had access to confidential information. Whilst this may make for rather compelling circumstantial evidence, it is not, and should not, be enough to support a criminal conviction on its own.

We have considered the law of three jurisdictions. Both the United Kingdom and Canada have devoted lengthy statutory provisions to insider trading and threaten potentially heavy penalties for offenders. The United States however, has no statute which deals specifically with insider trading and instead has left the development of the law to the SEC and the courts, hanging liability loosely on section 10(b) of the Exchange Act[1], a provision which almost certainly was not enacted with this in mind.

However, in terms of efficacy, the United States is clearly ahead. But at what expense? This area of law has at best developed unevenly, at worst erratically, and is still something of a minefield – dangerous and unpredictable. Of course, this is in part due to the federal system – different courts in different states will inevitably produce different decisions – but it is also because there is no statutory definition of insider trading. There can be no valid justification for such a lack of definition in a country which prides itself on having supreme constitutional protection of human rights. Financial penalties for insider trading can be crippling, and worse still, offenders risk losing, and do lose, their liberty upon conviction. The SEC's reluctance to define insider trading is unsurprising since it is clearly easier to secure convictions for an offence which has few limits.

[1] *Securities Exchange Act* of 1934, 15 U.S.C. s. 78a (Law Co-op., 1996).

However, the courts and Congress do have a duty to tackle this difficult offence and to set boundaries.

In practical enforcement terms the United States has adopted different strategies to its counterparts in the United Kingdom and Canada, who still struggle with the evidential problems that insider trading by its nature causes. Two such tactics used by the SEC are worth noting. First, having identified an insider trading ring, the SEC makes deals with some members of the ring in exchange for their testimony and assistance in convicting other members. Whilst this method is effective, providing the SEC with more than the usual circumstantial evidence relied on by enforcement agencies, it does not always achieve justice. One such deal was that negotiated by the notorious Ivan Boesky in the Milken/Boesky insider trading scandal of the 1980s. In exchange for his co-operation, the SEC allowed Boesky to profit from perhaps one of the biggest insider trades of his career. Namely, the SEC agreed to let Boesky dispose of his substantial investments in securities prior to announcing the outcome of their investigations, which ultimately had a devastating effect on the market. Boesky was able to avoid dramatic losses as a result.[2] The second notable and equally effective tactic, is to pay informants handsomely for their testimony. In fact, as has been noted, the SEC may to use the fines ultimately recovered from offenders to pay informants under the Insider Trading Sanctions Act.[3]

It will be interesting to see whether a similar approach will be taken by the new U.K. Financial Services Authority (FSA). Theoretically, the broader powers entrusted to this institution under the Financial Services and Markets Act[4] should allow it to undertake more in-depth investigations and ultimately to sanction, as it deems appropriate, clear cut cases of insider trading without recourse to the courts.

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[2] See generally D. Levine, *Inside Out*, (New York: Century, 1991) and J. Stewart, *Den of Thieves*, (New York: Simon and Schuster, 1991).
[3] *Insider Trading Sanctions Act of 1984*, Pub. L. No. 98-376, 98 Stat. 1294.

It is likely that the extent to which the FSA does this will depend more on the political climate in the United Kingdom than on other considerations, since as we have seen, for many years statutory tools, as in Canada, have been provided to regulators, but convictions have always been few and far between. It remains to be seen how the British public will react to a harsher approach to insider trading, by the FSA.

Indeed it is the public's attitude, and that of judges and academics, which appears to be in reality the determining factor. In terms of the general attitude towards insider trading, Canada and the United States sit at the opposite ends of the spectrum, and the United Kingdom has so far fallen somewhere in the middle.

With respect to Canada, an analysis of the provisions of the Ontario Securities Act[5] shows that in theory the offence of insider trading is fairly broad, and given that one would expect to see a high number of convictions. However, the socio-political climate is such that the courts are reluctant to convict quite blatant offenders, the Doman-Bennett saga being a classic case on point.[6] This attitude is mirrored in academic writings which do not view insider trading with the same seriousness as do American writings. In fact, in Canada, very little has been written about insider trading at all. Any research on insider trading reveals hundreds of academic articles written in the United States but very few written by Canadians. Similarly in the United Kingdom, although not as popular as in the United States, insider trading has been discussed by many academics at length and several textbooks are devoted to the subject alone. In Canada, insider trading receives no more attention than one chapter in general securities law textbooks and only brief references in those texts devoted to corporate law.

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[4] *Financial Services and Markets Act 2000* (U.K.), 2000, Chapter c. 8.
[5] Ontario *Securities Act*, R.S.O. 1990, c. S.5 (as amended).
[6] See Chapter Three, section II B 4 above.

The reason for such variance is that insider trading essentially comes down to a shared view of morality and ethics. In the United States, where the public actively participates in the stock market, insider trading is believed to cause significant harm as it unbalances the ideal level playing field. In Canada however, the general attitude appears to be that participation in the stock market is inherently risky and insider trading is just another one of those risks which should be factored in to the decision to trade, and whilst the view seems to be that it should be regulated, there is a reluctance to view deviant conduct as deserving a criminal label.

A similar low number of convictions in the United Kingdom in spite of sophisticated statutory provisions would suggest a similar distaste for criminalisation. This is probably for two reasons. The first is that the victim of the insider trading is often not discernible. The second is that the victim chose to trade with the insider at that price and also knew the risks of trading in securities. This does not make for a very sympathetic scenario.

Moreover, the nature of insider trading is such that it does not lend itself to criminalisation simply because it is virtually impossible to prove beyond all reasonable doubt without employing arguably dubious tactics to bolster the circumstantial evidence. Of course the offence could be defined in more simple terms, and a heavier burden placed on the defendant to prove that he was not engaged in insider trading when the circumstantial evidence points clearly to the contrary.

For example a clear presumption that a defendant had traded on the basis of inside information if he trades in securities whilst in fact in possession of information about those securities, would take the problem of second guessing the defendant's thoughts out of the equation. In the case of insider trading, such a rebuttable presumption would not be entirely unreasonable since, as the *Adler* court pointed out, information cannot lay idle in the human brain.[7] It is highly likely that a person who trades whilst in possession of information will make use of that information when deciding to buy or sell.

Alternatively, defendants could simply be required to explain suspicious trades. In the United Kingdom, an adverse inference can be drawn from a defendant's silence. In theory therefore, convictions based on circumstantial evidence should be easier to secure than in the United States where a defendant's right to silence in order to avoid self-incrimination is sacrosanct.

Such in-roads into fundamental human rights though are not justified for the sake of proving insider trading. A better approach would be to accept that use of the criminal justice system is probably not the best way of dealing with this offence. Since it is the market as a whole that is affected by insider trading, and not in reality specific victims, market regulators should be left to deal with it as they consider fit. The criminal courts are neither adequate nor appropriate forums for sanctioning insider trading. Moreover, the presence of rarely enforced criminal statutes does little to instil public confidence in justice or to act as a deterrent.

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[7] *SEC v. Adler* 137 F.2d 1325, 1337-39 (11th Cir. 1998).

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