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Disparate Notions of Fairness

Comparative Insider Trading Regulation in an Evolving Global Landscape

JOAN MACLEOD HEMINWAY

Should it be legal for entities and individuals who possess important nonpublic information about a corporation, its management, or its securities to trade in the corporation's securities in the open market or with individuals who lack knowledge of the nonpublic information? If the answer to this question is *not* an unqualified "no," then under what circumstances should this kind of trading be permitted or prohibited? These questions are the essence of the law of insider trading, a body of law that has slowly proliferated and evolved from state to state as securities and other financial markets multiply and become more established and as international and cross-border securities trading has become more prevalent.

Given the relatively recent introduction of insider trading regulation in many states, the study of international and comparative insider trading (and other aspects of corporate governance and corporate finance) lags somewhat behind the study of more traditional areas of public international law. This lag is unfortunate given the increasingly international scope of business and, more specifically, corporate finance. Yet even with the comparatively recent advent of international and comparative scholarship in the area of insider trading regulation, one thing is quite clear: Different states regulate insider trading in quite different ways and with quite different policy objectives and effects. Each of these systems of regulation has benefits and detriments. But the fact of their difference is, in itself, an important issue in international law and business. Without agreement across states on what, precisely, is *legally* objectionable about insider trading, cross-border investors who are trading while in possession of important nonpublic information cannot be sure whether their conduct is legal. This uncertainty is compounded by ambiguities associated with the boundaries of regulatory and enforcement jurisdiction. Differences in insider trading regulation from state to state may have undesirable effects on cross-border transactions as well as both developed and emerging markets, with those investors intent on extracting individual profit from nonpublic information fleeing certain securities markets and entering others.

The many facets of international and comparative insider trading regulation that contribute to its uncertain international regulatory status are too numerous to cover in one chapter. Accordingly, this chapter analyzes global insider trading regulation from one uniformly understood perspective—fairness. Although fairness is not the policy underpinning of insider trading law in all states that legally restrict

insider trading (and, in the eyes of some, is not a legitimized objective in regulating insider trading[1]), it is commonly offered as a rationale for restricting trading for those possessing important nonpublic information. To understand insider trading from this angle requires that we first understand the concept of fairness. Once we have that fundamental understanding of fairness, we can look at basic principles of insider trading regulation in different states (here, I focus on the United States, Japan, and Germany), the divergent development of insider trading regulation in these states, and various aspects of insider trading regulation in different states through the lens of fairness. This description and analysis sheds light on the gaps among national regulatory frameworks that must be closed in order for effective international regulation to occur. Although the International Organization of Securities Commissions has undertaken efforts to standardize international securities regulation (including by fostering insider trading regulation among its members),[2] this chapter assumes that greater international coordination of insider trading regulation is a desirable objective.

Defining Fairness in the Context of Regulation

Fairness, as a first principle in international and other law, both serves as a filter (or test) for lawmakers in identifying, selecting, and combining legal prescriptions and proscriptions, and it then characterizes the result of that process. Yet fairness is somewhat difficult to precisely and uniformly define; in fact, multiple conceptions of fairness exist and are accepted.[3] Fairness may be coextensive with consensual agreement, untainted by duress or deception.[4] Fairness may be seen as synonymous with equity—but not with formal equality (although equal treatment may sometimes be fair).[5] According to the Merriam-Webster Online Dictionary, the root adjective "fair" means (in the relevant part) "marked by impartiality and honesty" or "free from self-interest, prejudice, or favoritism" or "conforming with the established rules."[6] These basic, general definitional words are packed with meaning. What is impartial or honest about a particular type of regulation? What does it mean for regulation to be "free from self-interest, prejudice, or favoritism" or to conform to established rules?

The seminal philosophical work of John Rawls approaches and resolves these issues by describing a construct for societal development and maintenance. Specifically, in *Justice as Fairness*, Rawls defined fairness as the basis for a system of cooperation in pluralistic, democratic society, and in doing so, he equated fairness with reasonableness.[7] According to Rawls, fairness, as a basis for regulation and other societal decision making, constrains the individualism that is permitted in a society that incorporates freedom and equality for the greater good of the whole.[8] In a fair system of societal cooperation, people who are free and equal have two moral powers: "the capacity for a sense of justice" and "the capacity for a conception of the good."[9] These powers effectively describe human circumstance. The capacity for a sense of justice allows free and equal members of society "to understand, to apply, and to act from (and not merely in accordance with) the principles of political justice that specify the fair terms of social cooperation."[10] Without the capacity for a sense of justice, there can be no fair system of societal cooperation—no way of arbitrating among various individuals' conceptions of the good. The capacity for a conception of the good allows free and equal members of society "to have, to revise, and rationally to pursue . . . an ordered family of final ends and aims which specifies a person's conception of what is of value in human life or, alternatively, of what is regarded as a fully worthwhile life."[11] A person's conception of the good includes one or more things to which the person aspires in life. There is room in this Rawlsian vision of fairness for personal asset accumulation and prosperity: "Income and wealth are general all-purpose means required to achieve a wide range of (permissible) ends, whatever they may be, and in particular, the end of realizing the two moral powers and advancing

the ends of the (complete) conceptions of the good that citizens affirm or adopt."

This philosophical conception of fairness is helpful, even if not completely transparent in its application. Rawls did, however, make at least one truly useful contribution in defining fairness as an applied first principle: decision making from the "original position" and, more precisely, from behind the "veil of ignorance":[12]

> the original position is a device of representation: it models, first, what we regard (here and now) as fair conditions for the terms of social cooperation to be agreed to (reflected in the symmetry of the parties' situation); and second, it models what we regard (here and now) as reasonable restrictions on reasons that may be used in arguing for principles of justice to regulate the basic structure. Various formal constraints of the concept of right are modeled in the original position by requiring the parties to evaluate principles of justice from a suitably general point of view. However rational it might be for parties to favor principles framed to promote the determinate and known interests of those they represent, should they have the opportunity, the constraints of right, joined with the limits on information (modeled by the veil of ignorance), make that impossible.

The veil of ignorance, as a key condition of the original position, specifies that societal decision makers approach their task with an ignorance of both their own position and that of others.[13] It "removes differences in bargaining advantages, so that in this and other respects the parties are similarly situated," and this, as a result, makes the original position fair.[14]

Specifically, from behind the veil of ignorance, societal decision makers can identify, adopt, and implement principles of justice in their decision making. Rawls articulated two principles of justice: that "Each person has the same indefeasible claim to a fully adequate scheme of equal basic liberties" and that "social and economic inequalities are to . . . be attached to offices and positions open to all under conditions of fair equality of opportunity . . . and they are to be to the greatest benefit of the least-advantaged members of society (the difference principle)."[15] Regulators in a fair system of regulation would, therefore, determine the existence, nature, and extent of regulation not as a means of addressing the concerns or desires of a particular interest group or groups (as public choice theory posits) but rather by reference to and application of foundational, accepted principles of justice that take into account the interests of all constituents, from the most to the least advantaged. Specifically, Rawls stated that the second principle of justice "applies at the legislative stage and it bears on all kinds of social and economic legislation, and on the many kinds of issues arising at this point."[16] Regulation is fair, then, when it provides or fosters fair equality of opportunity and complies with the difference principle (the two aspects of the second principle of justice).

Others have posited alternative conceptions of fairness in a legal context. In one law review article, for example, the author described two different ways of looking at fairness in rulemaking:

> The term "fairness" has at least two possible meanings. In one sense, it means an action, decision, or state of affairs that reflects the best overall balance of competing values and interests. This is the sense one means when one refers to a regulation that reflects a compromise among conflicting interests as a "fair" resolution of the controversy. It is a fair resolution if it strikes a good balance among all the affected interests—those of consumers, regulated parties, and the public at large.
>
> "Fairness" also has a narrower and more precise meaning. In this second sense, the term denotes one set of values in the overall normative calculus: those, such as rights-protection and distributive justice, that focus on how individuals are treated rather than how everyone benefits in the aggregate. This is the sense of fairness one means when one contrasts fairness with efficiency or utilitarianism. In our regulation example, fairness in this second sense refers to

how the regulation affects each consumer and each regulated interest, apart from how it affects social costs and benefits overall.

More precisely, fairness in this second sense denotes a normative claim that can limit or constrain decisions aimed at maximizing aggregate welfare. Fairness is concerned with how persons are treated either individually or in relation to one another—whether their rights are respected, for example, or whether they are treated as equals in the distribution of social goods. For instance, an egalitarian might invoke fairness to object to an unequal distribution of wealth on the ground that the distribution is unjust even if it also increases total social wealth in the long run by allocating larger shares to more productive individuals.[17]

These two alternative, non-Rawlsian definitions of fairness both require the comparative analysis of societal actors in different positions; but each resolves inequalities in different ways—the first by balancing competing individual interests for the good of the whole and the second by focusing on the treatment of individual actors.

Yet these three conceptions of fairness are not exclusive, nor are they necessarily guidance for rule makers. Rule makers may not be (often are not) clear about whether fairness is the basis for a particular rule or in what conception of fairness a specific rule is rooted. Some or all notions of fairness may be flawed, but they each have proponents as well as detractors. Be this as it may, disparate notions of fairness may present a basis or explanation for some variations in legal rules among states, including variations in insider trading regulation.

Basic Principles of Insider Trading Regulation

Many states ostensibly use (or at least credit) U.S. insider trading doctrine under Rule 10b-5[18] as the model for their own regulation of insider trading.[19] This phenomenon has occurred in part because of historical and political factors and in part because the United States is seen as (and has wielded regulatory power as) a market leader—an early adopter of regulation with both (a) a well-established supervisory and policy-oriented regulatory and enforcement agency, and (b) a well-developed, disaggregated, public securities market. As a result, the laws of many countries now prohibit identified classes of persons from trading while in possession of material nonpublic information, which is the central focus of insider trading regulation under Rule 10b-5.[20]

Yet despite seemingly convergent beginnings and a general agreement on the nature of the regulated conduct, operative insider trading principles in the United States (as a rule originator) have evolved to protect different interests and regulate different specific market activities than insider trading rules have in other countries.[21] For example, because of its origins in the context of an antifraud rule prohibiting manipulation and deception in connection with the purchase or sale of securities, U.S. insider trading doctrine fosters, supports, and protects, first and foremost, a fiduciary or fiduciary-like duty (that of an agent to a principal) rather than affording primacy to informational fairness (whether in the form of equal access to information or strict informational parity).[22] Also, the definition of an “insider”—the person regulated in his or her trading activities—varies from country to country, with the United States defining the concept to include any individual having a specified duty of trust and confidence (the fiduciary or fiduciary-like duty referenced in the preceding sentence) rather than a specified person or entity affiliated or associated with the issuing corporation in a defined way.[23] Moreover, U.S. insider trading rules broadly protect investors against market and nonmarket risks (through an expansive definition of materiality), whereas regulation in other countries purports to protect investors against market risks only (by focusing on market-affecting information).[24] And finally, because unlawful insider trading in the United States involves

deceptive conduct, U.S. insider trading violations require proof of scienter—an ill-defined state of mind requirement that, according to the U.S. Supreme Court, consists of "a mental state embracing intent to deceive, manipulate or defraud."[25]

This essay focuses on the insider trading laws of three developed states: the United States, Japan, and Germany. Their laws have a common doctrinal, policy, and enforcement foundation, owing in no small part to the fact that U.S. insider trading doctrine was transplanted into (first) Japan and (much more recently) Germany as part of an international effort to encourage insider trading regulation consistent with the predominant U.S. model. Each state's law prohibits people from trading on the basis of important nonpublic information. Yet those who are regulated and the nature of the protected information vary from state to state. Moreover, the law has been adopted and has developed in different ways in each state due to (among other things) common law/civil law distinctions between the United States, on the one hand, and Japan and Germany, on the other, as well as external pressures from the international community, in general, and from supranational governance structures, in particular—in this case, the European Community.

U.S. Insider Trading Regulation

In the United States, insider trading is principally regulated under Rule 10b-5, although the rule is not narrowly tailored to address insider trading alone.[26] Rather, it is a general antifraud prohibition that has been shaped, principally by judge-made law, to include insider trading, among other practices. Adopted in 1942, Rule 10b-5 makes it

> 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]

Typically, unlawful insider trading is deemed to violate subparagraph (a) or subparagraph (c) of Rule 10b-5 because insider traders remain silent; they withhold, rather than make, statements, oftentimes in the absence of other statements that are then made misleading by the insider trader's lack of disclosure.[28] I parenthetically note here an important linguistic difference: in the United States, the term "insider trading" is used to describe only illegal trading by those deemed to be insiders for Rule 10b-5 purposes; in many other states, the term "unlawful" (or "illegal" or "prohibited" or the like) must be used to indicate trading by insiders that constitutes a violation of law.

The adoption of Rule 10b-5 by the Securities and Exchange Commission ("SEC") is authorized under Section 10(b) of the Securities Exchange Act of 1934, as amended ("Section 10(b)" and the "1934 Act," respectively).[29] Section 10(b), like Rule 10b-5, is broadly worded and applicable to securities fraud that includes, but is not limited to, insider trading. In particular, Section 10(b) prohibits "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" from using or employing

> in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[30]

Specific restrictions developed in decisional law construing Section 10(b) and Rule 10b-5 legally prohibit (under certain circumstances) both securities trading transactions and tipping information in connection with securities transactions as unlawful deceptive activities. Early cases painted a general deception argument for applying Section 10(b) and Rule 10b-5 in this context—deception grounded in informational unfairness or inequity (though admittedly leaving parts of the relevant doctrine unclear and undecided). For example, in 1951 the U.S. District Court for the District of Delaware explained its application of Section 10(b) and Rule 10b-5 to facts involving insider trading:

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the 'special circumstances'. One of the primary purposes of the Securities Exchange Act of 1934 . . . was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders. I gave approval to this view of the Act in an earlier opinion in the case at bar.[31]

Only with a 1961 SEC enforcement action, however, did modern U.S. insider trading law permanently and inextricably (at least to date) link itself to Rule 10b-5.[32] The SEC's decision in this action, In re *Cady, Roberts & Co.*, is credited with establishing the "disclose or abstain" rule at the heart of current insider trading doctrine under Rule 10b-5.[33] Under the "disclose or abstain" rule, a corporate insider must either disclose all material nonpublic facts in his or her possession or refrain from trading the corporation's securities.

> We, and the courts, have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.[34]

As illuminated and defined in subsequent case law, a fact is material if there is a significant likelihood that a reasonable investor (1) would find it important in making a buy/sell decision or (2) would find that disclosure of the fact significantly alters the total mix of publicly available information;[35] a fact is public if it has been "effectively disclosed in a manner sufficient to insure its availibility [sic] to the investing public."[36]

Cady, Roberts was followed by a number of other cases in federal court, notably including *SEC v. Texas Gulf Sulphur*,[37] endorsing and applying the "disclose or abstain" rule. Like earlier court and SEC decisions on insider trading, *Cady, Roberts* and these other cases are expressly premised on the unfairness associated with an insider's beneficial use of undisclosed information obtained by the insider because of his, her, or its insider status.[38]

In the post–*Cady, Roberts* era, the basic tenets of U.S. insider trading doctrine under Section 10(b) and Rule 10b-5 have been shaped principally by opinions in three U.S. Supreme Court cases decided over a seventeen-year period. The first of these opinions, the Supreme Court's 1980 decision in *United States v. Chiarella*,[39] endorses

and reinforces the "disclose or abstain" rule articulated in *Cady, Roberts*. Under *Chiarella*, public issuers of securities and their insiders—people with a fiduciary or fiduciary-like duty of trust and confidence to shareholders—cannot trade in the issuer's securities while in possession of material, nonpublic information.[40]

Three years later, in 1983, the Supreme Court decided *Dirks v. SEC*.[41] *Dirks* regulates tipping by an insider and trading by a tippee—a person who obtains information directly or indirectly from an insider for an inappropriate purpose.[42] Effectively, under *Dirks*, (1) a tipping insider is liable if he breaches his fiduciary duty to the corporation and its shareholders by improperly (i.e., in expectation of a personal benefit) disclosing material nonpublic information and (2) a tippee is liable if the tipping insider breaches his fiduciary duty by improperly disclosing material, nonpublic information to the tippee and the tippee knows or should know of the breach.[43] As long as these requirements for tipper or tippee liability are met, an insider tipper may be held liable for trading by a tippee who does not receive information directly from the insider, and a tippee may be held liable for a trade made while in possession of material, nonpublic information received only indirectly from an insider.[44]

Finally, in 1997 the Supreme Court decided the third case in the trilogy, *United States v. O'Hagan*.[45] The *O'Hagan* case prohibits securities trading by a person who is not an insider of the corporation who possesses material, nonpublic information obtained from a source (other than an insider) to whom or which the trader owes a duty of trust and confidence.[46] The insider trading liability in this context is based on the trader's "deception of those who entrusted him with access to confidential information."[47]

These three cases outline the basic principles of insider trading in the United States today. As a group, they prohibit at least four securities trading–related activities: trading by insiders in possession of material, nonpublic information (known as the "classical theory" of insider trading liability); improper insider disclosure of material, nonpublic information directly or indirectly to noninsiders who may trade on that information (known as "tipper liability"); trading by noninsiders who receive material, nonpublic information directly or indirectly from insider tippers who share that information improperly, if the noninsider knows that the information was shared improperly (known as "tippee liability"); and trading by those who possess material, nonpublic information and breach a duty of trust and confidence to the source of that information by engaging in the trade (known as the "misappropriation theory") of insider trading regulation. The SEC summarizes the overall insider trading proscription as follows:

> The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act . . . and § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.[48]

Actions for violation of these insider trading prohibitions can be criminal (brought by the Department of Justice, U.S. Attorney's office) or civil (brought by the SEC in federal court or in an administrative action or by private parties, including through class action litigation). Enforcement activity varies from year to year but is significant. For example, from 2001 to September 22, 2006, the SEC alone brought 300 cases primarily classified as insider trading cases.[49]

Japanese Insider Trading Regulation

Enacted in the shadows of World War II, the overall securities regulation regime in Japan is modeled after the U.S. securities laws.[50] Although the Japanese Securities and Exchange Law of 1948 (the *Shoken Torihikiho*, or "SEL,"

now known as the Financial Instruments and Exchange Act, or "FIEA") included a provision similar to U.S. Section 10(b), it was not and is not used to enforce insider trading prohibitions:[51]

> Although it was never used in an insider trading case, old Article 58 carried a penalty of no more than three years in prison, or a fine of no more than three million Yen, or both. There are several reasons why this Article was never used. First, the Japanese public did not care who gained and who lost in an insider trading case. Until the 1980's few Japanese individuals bought securities on the market. Securities trading was thought to be "professional work"—a term which has a negative meaning, as in gambler, cheater, or gang member. An honest person would work hard, but not to buy shares—because share prices were controlled by professionals and you never could win. Only professionals played the game with professionals. . . . Second, politicans [sic] raise campaign funds through or take bribes from the securities market. . . . Politicians raise funds not only by manipulation but also by insider trading. Third, and most importantly, the Article 58 wording was too vague and its scope too broad to be used effectively against insider trading. This Article could be applied to any kind of securities, whether listed, traded on the over-the-counter (OTC) market, held privately, or issued by governments or foreigners. Anyone who did any kind of fraudulent act under the Article was liable.[52]

A more direct form of insider trading regulation was implemented in 1988 in response to pressure from the United States and other developed states.[53] Then-current facts indicating a significant instance of insider trading also acted as a catalyst for the 1988 changes:[54] "The 1988 amendments are premised on the concept that insider trading is unfair and violations rightfully should be punished."[55] Accordingly, Japanese insider trading law prohibits corporate insiders knowing material facts about the business of a listed company from making a sale, purchase, or assignment or acquisition for value of a security of the listed company until the material fact has been made public.[56] Interestingly, under Japanese law, although it is unlawful for a tippee receiving material facts about a listed company directly from an insider to trade in the securities of that listed company,[57] the statute does not provide for indirect tippee liability, tipper liability, or liability premised on misappropriation.[58]

Despite Japan's relatively early and comprehensive statutory regulation of securities transactions and insider trading, enforcement of insider trading prohibitions in the wake of the 1988 amendments to the SEL was not immediately forthcoming.[59] In the 1990s enforcement activity increased, although not by any measure to the level of enforcement activity in the United States.[60] This increase in enforcement, like the 1988 adoption of direct insider trading regulation in Japan, was in part a response to pressure from the United States.[61] However, factors inside Japan handicapped enforcement efforts, even as external pressures increased. One commentator offered that "a significant factor in the Japanese government's non-enforcement of its insider trading laws may be the 'widespread participation of Japanese politicians in insider trading.'"[62] Despite these factors, however, with the introduction of civil fines in 2005 amendments to the SEL, Japanese insider trading enforcement has continued to increase in the new millennium.[63] Assessments of these fines are made by an administrative order after an administrative investigation.[64] These orders, unchallenged by the alleged violators, represent significant progress in enforcing insider trading prohibitions in Japan.[65] Press reports indicate that insider trading fines have been doubled from previous rates, adding further retributive and deterrent value to insider trading enforcement in Japan.[66]

German Insider Trading Regulation

Until 1994 Germany had no law against insider trading. Instead, insider trading was regulated

informally through nonbinding guidelines in place (adopted in 1970 and amended in 1976 and 1988) and stock exchange rules that prohibited insiders from engaging in certain trading transactions.[67] These informal pronouncements were wholly unsuccessful as a means of combating German insider trading.[68]

Then, in 1994 Germany criminalized insider trading.[69] Germany was the last EC member to pass insider trading regulation, having failed to enact legislation by the June 1, 1992 deadline set by the first EC Directive on insider trading, issued in 1989.[70] A second EC Directive was adopted in 2003, resulting in adjustments to the original regulatory framework.[71]

The United States, acting through the SEC, was an impetus behind both the EC Directive and, ultimately, Germany's law.[72] Other factors also "contributed to the . . . legislative drive to improve the Finanzplatz Deutschland, including increased pressures to compete internationally, harmonize European capital markets, assist international enforcement efforts, and adapt to technological developments."[73] Like Japan, Germany was dealing with capital market dislocations (attributable to various causes, including a then-current insider trading scandal) when it adopted legislative insider trading prohibitions.[74]

Under Germany's insider trading law,[75] "Insiders cannot buy or sell securities based on nonpublic information, cannot convey this information to another person, and cannot recommend that others trade in securities based upon such information. A third person who becomes aware of inside information is also prohibited from such actions."[76]

Enforcement is supervised by a federal agency organized under the German Ministry of Finance—initially, the Federal Supervisory Authority or Federal Supervisory Office ("FSA" or "FSO" or, from the original German, "*BAWe*"), and now the *Bundesanstalt fur Finanzdienstleistungsaufsicht* (or "*BaFin*").[77] The law contemplates "a three-tiered surveillance structure on the federal, state (*Lander*), and exchange levels."[78]

In Sum

The United States was an early adopter of insider trading regulation and became the international leader in the diaspora of that regulation among states with developed public securities markets.[79] Not content to rest after achieving its regulatory objectives at home, the United States, through the SEC, has successfully promoted the adoption of its brand of insider trading regulation in other countries, including Japan and Germany:

> Apart from its interest in protecting U.S. investors from insider trading, irrespective of wherever such trading is effected, the SEC has executed its global crusade against insider trading on the assumption that such transactions are inimical to the development of other national markets, and hence the international market. However, no consensus exists among other national regulators and market participants that such transactions have an overall negative effect on their markets. This is most evident from the laxity with which insider trading laws have traditionally been enforced in many of these jurisdictions. Cases in point are Japan, where insider trading laws were instituted under U.S. influence after the Second World War, and Germany where such laws were grudgingly passed pursuant to a directive of the European Community.[80]

The insider trading laws adopted by Japan and Germany are, at their respective cores, built on the same "disclose or abstain" rule enunciated in the United States in the *Cady, Roberts* enforcement action in 1961. Moreover, although actual enforcement of insider trading laws has been inconsistent over time,[81] Japanese and German insider trading laws provide for enforcement through regulatory bodies modeled after the SEC.[82]

A number of commentators have noted these and other similarities in the regulatory frameworks of the three countries and, from this, have

assumed regulatory convergence.[83] This assumption, however, proves to be flawed. The central commonalities of the three systems of insider trading regulation do not tell the whole story. A number of legal scholars have started to tell this more detailed version of the story,[84] and this chapter extends that literature.

Divergent Development of Insider Trading Regulation

Despite the common roots and substantial overall similarities of the prohibitions against insider trading in the United States, Japan, and Germany, insider trading doctrine has developed differently among the three countries in a number of important respects.[85] In this part of the chapter, I describe and explain the significance of four of these divergent aspects of insider trading law development: the increasingly central role that agency law—and particularly agency-based duty—has come to play in U.S. insider trading regulation (which has not been transplanted or otherwise replicated in Japan and Germany); the dissimilar ways in which the three countries define who an "insider" (or other regulated person) is; differences in defining the type of information that may trigger the application of the "disclose or abstain" rule; and the distinctive requirement of scienter in U.S. insider trading law. Each of these aspects of insider trading law is important in that the differences contribute meaningfully to an understanding of the interests regulated and protected through insider trading doctrine and to an understanding of the transaction costs associated with trading and communication decisions.

The Unique Requirement of a Breach of Duty in the United States

The regulation of insider trading can be justified along a number of different—but not wholly distinct—policy continuums, including safeguarding fiduciary duties relating to an agent's proper use of her principal's information, promoting fairness in the market for information (whether through equal access to or a strict parity of information), and protecting property rights in information.[86] In the United States, despite the SEC's continued promotion of an informational fairness rationale[87] and pointed scholarly critiques urging policy justifications other than the promotion of fiduciary duties,[88] insider trading doctrine has developed as a specific type of securities fraud, primarily rooted in fiduciary and fiduciary-like duty principles that originate in agency law. "Agency law provides a . . . comprehensive and coherent basis for dealing with the problem of insider trading, which is, at bottom, the misuse by faithless agents of information that belongs to others."[89]

Under general principles of agency law, agents are fiduciaries:[90] "An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."[91] Accordingly, "An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position."[92] As part of this duty, "An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party."[93] Commentary on this last, two-part expression of an agent's fiduciary duty further clarifies the agency law basis for insider trading prohibitions:

> An agent's use of the principal's confidential information for the agent's own purposes breaches the agent's duty as stated in subsection (2) although the agent's use of the information does not necessitate revealing it. Thus, it is a breach of an agent's duty to use confidential information of the principal for the purpose of effecting trades in securities although the agent does not reveal the information in the course of trading.[94]

The agent is liable to the principal for a breach of these prescribed duties.[95] Possible remedies

include avoidance of any related contract entered into by the agent, disgorgement to the principal of any benefit (or the value of or proceeds from the benefit) received by the agent, and related damages.[96]

In its opinion in the *O'Hagan* case (affirming the misappropriation theory),[97] the Supreme Court summarized the linkage between these agency law fiduciary duties and the U.S. law regarding insider trading:

> Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, 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." That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from . . . taking unfair advantage of . . . uninformed . . . stockholders.'" . . . The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information. [98]

Because, under U.S. insider trading law, a tippee effectively assumes the duty of the tipper if the tippee knows that the tipper had a duty of trust and confidence and breached that duty in making the tip, tipper and tippee liability also is premised on the breach of a fiduciary duty arising out of agency law.[99] Accordingly, based on Supreme Court doctrine, liability for insider trading in the United States is tied directly to the existence and breach of an agency law–based fiduciary or fiduciary-like duty.[100] As such, U.S. insider trading regulation under Rule 10b-5 is inextricably intertwined with agency law principles.[101]

Yet agency law does not perfectly sync with or fully explain insider trading regulation under Rule 10b-5. Notions of informational fairness—in the form of equal access, rather than information parity—and property right protections play a role (and arguably, based on recent lower court decisions and SEC activity, an increasing role) in regulating insider trading in the United States.[102]

Moreover, fiduciary duty principles do not well explain the law governing insider trading in other countries. Neither Japanese nor German law is rooted in securities fraud doctrine, and neither law ties insider trading liability to the existence and breach of a duty by a fiduciary or even the existence of a fiduciary or fiduciary-like relationship. Rather, these two states and "other jurisdictions soundly have rejected the U.S. fiduciary relationship (or relationship of trust and confidence) model to define the scope of illegal insider trading and tipping."[103] Instead, the insider trading doctrines in Japan, Germany, and elsewhere primarily serve informational fairness objectives. Specifically,

> Many countries opt for an insider trading proscription premised on the "access" doctrine. As a generalization, this standard prohibits insider trading by those who have unequal access to the material nonpublic information. This concept may extend the insider trading prohibition to tippees who receive the subject information from traditional insiders or others who, due to their office, employment, or profession, have access to such information.[104]

Although many in the United States do regard fairness as a significant policy consideration underlying insider trading regulation, the primary fiduciary duty emphasis of U.S. doctrine may compromise—and certainly eclipses—certain fairness considerations as a matter of law.[105]

These different policy emphases in insider trading regulation are significant in that they may be outcome-determinative as to questions of liability. Insider trading liability premised on a breach of fiduciary or fiduciary-like duty may be under- or overinclusive as compared to liability based on informational fairness. For example, a person who, as a result of her position or a personal or professional relationship with a corporate executive, comes to possess material, nonpublic information and trades on that information without any breach of a predicate fiduciary or fiduciary-like duty does not violate U.S. insider trading law under Rule 10b-5, but she is likely or sure to violate insider trading prohibitions under Japanese or German (or other similar) law. Conversely, a person possessing material nonpublic information who has and breaches a fiduciary or fiduciary-like duty by trading in securities violates U.S. insider trading law but may not violate the insider trading law of Japan, for example, if the trader's position does not make him a statutory insider (i.e., as defined under the law, afford him unequal access to inside information).

Disparate policy considerations also have meaning in terms of transaction and litigation planning. Specifically, reliance on nebulous and changing conceptions of fiduciary and fiduciary-like duty under U.S. insider trading law introduces transaction costs in the form of uncertainty and unpredictability into transaction and litigation decision making that are not present under Japanese and German insider trading law.[106] Over time, insider trading law in the United States has developed through SEC rule making and decisional law to incorporate and protect various different fiduciary or fiduciary-like relationships in which a person with knowledge of material, nonpublic information trades securities or tips others who then trade or pass on the tip to someone else. Because the existence and breach of a duty is often more difficult to discern in insider trading cases involving the misappropriation of material, nonpublic information, the SEC adopted a new rule under the 1934 Act in 2000, Rule 10b5–2, that sets forth (in paragraph (b) of the text) three nonexclusive circumstances in which a duty of trust and confidence is deemed to exist.[107] These circumstances include:

1. Whenever a person agrees to maintain information in confidence;
2. Whenever the person communicating the material, nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material, nonpublic information expects that the recipient will maintain its confidentiality; or
3. Whenever a person receives or obtains material, nonpublic information from his or her spouse, parent, child, or sibling—provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.[108]

This rule is at issue in a case that, at the time this chapter went to press, is being contended on appeal from a decision of the United States District Court for the Northern District of Texas, Dallas Division. The case, *SEC v. Cuban*,[109] involves trading in a corporation's securities by a noncontrolling shareholder who was given information about a planned securities offering—clearly material, nonpublic information—by the

chief executive officer of the corporation for proper corporate purposes: to encourage further investment by the shareholder in the planned offering. In the action, the SEC asserts that the defendant, Mark Cuban (entrepreneur and owner of the Dallas Mavericks basketball team), had a duty of trust and confidence under Rule 10b5–2(b)(1) because he agreed to maintain the information given to him confidentially. The federal District Court dismissed the action, finding that the agreement referenced in Rule 10b5–2 must impose both duties of nondisclosure and nonuse in order for it to be deceptive and, therefore, consistent with the authority granted to the SEC by the Congress in Section 10(b).[110] Accordingly (and this is important to remember when applying any SEC rule or interpretive pronouncement), the list of circumstances set forth in Rule 10b5–2 may not be definitive on its face and must be read in the context of the authorizing statute—here, the law governing insider trading under Section 10(b).

Moreover, Rule 10b5–2 does not purport to define relationships of trust and confidence for all insider trading activity that is unlawful under Section 10(b) and Rule 10b-5. Although Rule 10b5–2 supplies a list of circumstances in which the requisite duty of trust and confidence exists in misappropriation cases, the list is nonexclusive. Moreover, there is no well-defined list of relationships in the statutes, administrative rules, or decisional law that identifies the liability-creating fiduciary or fiduciary-like duties in cases not involving misappropriation; apart from precedent and nonbinding guidance provided in federal court opinions, the law of agency, which in theory may evolve from case to case, provides the outer limits of a definition in those contexts.[111] Accordingly, it may not be easy for a transaction participant to know or understand in advance that he or she owes or is breaching a fiduciary or fiduciary-like duty that may subject him or her to insider trading liability under any of the existing theories. Similarly, enforcement agents and potential private plaintiffs may not find it easy to identify and prove the existence and breach of a fiduciary or fiduciary-like duty in order to plead and prove a claim. Conversely, informational fairness principles in Japanese and German insider trading regulation are largely articulated in the relevant statutory provisions, thus enhancing certainty and predictability for transaction and litigation planners.

Policy-related uncertainty and unpredictability under U.S. insider trading doctrine is exacerbated by enforcement activities undertaken at the margins of allegedly proscribed activity. Over the years, criminal prosecutions brought by the U.S. Department of Justice as well as administrative or judicial enforcement actions brought by the SEC have attempted to expand the scope of potential liability by (among other things) adding to the fiduciary and fiduciary-like duties that may be culled from decisional law. The Department of Justice's prosecution of the *O'Hagan* case and the SEC's enforcement actions against Martha Stewart (as the purported tippee of an alleged misappropriator) and Mark Cuban are salient examples of these expansive interpretations of U.S. insider trading policy and doctrine.[112]

Defining Insiders and Others Whose Conduct Is Regulated

To achieve underlying national policy objectives, operative insider trading law in the United States, Japan, and Germany regulates a range of securities trading conduct in which specific types of people are engaged. The market participants whose conduct is regulated under each state's law are different, and they are identified with varying levels of specificity.

Under U.S. law, an insider (defined broadly to include classical insiders, tippers, tippees, and misappropriators—the last of these sometimes referred to as "outsiders") is a person with a direct or derivative duty of trust and confidence emanating from agency law.[113] The specific positions or relationships that create insider status are defined in Rule 10b5–2 and through judicial decisions in insider trading cases. It is widely acknowledged that key corporate executives, corporate directors, and controlling shareholders—

as well as corporate advisers (like lawyers and accountants) are insiders of the corporation they control or serve.[114] Because it is unclear under U.S. law whether U.S. government officials have a fiduciary or fiduciary-like duty that would be breached by trading or tipping, federal legislation was introduced in the United States to prohibit (a) trading while in possession of material, nonpublic information and tipping material, nonpublic information by members of the executive Branch, members of Congress, and congressional staff and (b) trading by tippees of material, nonpublic information obtained from the Executive Branch or Congress.[115]

Masanori Hayashi has noted that "Japanese law on insider trading, codified in the *Shoken Torihikiho*, follows the U.S. statutory and common law schemes in some respects."[116] Japanese insider trading law defines insiders to include corporate officers, employees, agents, and shareholders having access to corporate records; those with statutory authority over the corporation; and those who come to know material facts in contracting with the corporation (and the officers, employees, and agents of contracting parties that are entities).[117] This list of regulated individuals and entities includes potential traders who are not regulated under U.S. insider trading law. As Franklin A. Gevurtz explained,

> The traditional theory in the United States would not pick up individuals obtaining information through a government supervisory role, as does the Japanese prohibition. Moreover, individuals obtaining information by virtue of a contractual relationship with the corporation would not count as insiders of that corporation under *Dirks* unless there is an expectation that they will hold the information in confidence. By contrast, under Japanese law, a contractual relation giving access to non-public information evidently is enough regardless of the expectation of confidentiality.[118]

However, Japan's statutory list of insiders also may exclude potential traders who would be deemed insiders under U.S. law:

> Japanese law does not prohibit trading by persons who gain information through professional relationships other than with the corporation whose stock they trade, or with a corporation making a tender offer for the stock they trade. Of course, in many instances—such as when attorneys and financial advisors obtain non-public information through working on the personal behalf of insiders—traders who obtain information through professional relationships could be liable as tippees under the Japanese statute.[119]

Japanese insider trading law does regulate trading by tippees—but only trades made by tippees who receive material, nonpublic information directly from insiders.[120] In both cases, these regulated persons (individuals and entities) are listed and described directly in the statute. Unlike U.S. law, the Japanese statute regulates neither tippers nor misappropriators.[121]

German insider trading law takes the broadest approach to this issue, prohibiting (1) the use of material, nonpublic information in trading, making trading recommendations, or inducing trading and (2) the tipping of material nonpublic information by any individual or entity.[122] Although prior versions of the German statute formally separated regulated insiders into primary and secondary insider groupings to the same (or a substantially similar) effect, the current statute is efficient and streamlined, relying merely on its definition of inside information and its articulation of proscribed actions to identify those whose conduct is regulated.[123] The German conception of insider status seemingly incorporates all those who are insiders under U.S. law and Japanese law.[124] Its breadth is a direct result of EC pronouncements[125] and may be a reaction to (among other things) concerns under the prior statute that government officials who leak material, nonpublic information to market participants may not have been liable for that conduct.[126]

The varied notions of an insider (or other person regulated as an insider) under the insider trading laws of the United States, Japan, and Germany, like insider trading policy distinctions

among the three countries, have both substantive and process-oriented implications. In fact, because U.S. insider trading law protects an agency law fiduciary duty principally by defining insiders as persons who have that duty, the earlier noted significance of national policy differences plays out in part through each country's conception of the insider.

The differing bases for determining insider status under U.S., Japanese, and German law may be outcome-determinative; different people will be held liable for trading, tipping, and other related activities under each system of insider trading regulation. For example, government officials who trade while in possession of material, nonpublic information may not be liable under U.S. law but are liable under Japanese and German law.[127] In addition, tippers, remote tippees, and misappropriators who trade on the basis of material, nonpublic information are liable under U.S. insider trading law and under the German statute but are not liable under the Japanese statute.[128]

The different national conceptions of an insider also generate different transaction costs for transaction and litigation planners. Under U.S. insider trading law, transaction and litigation planners need to assess whether traders possessing material, nonpublic information or those disclosing material, nonpublic information to others are among the direct or indirect fiduciaries for whom trading and tipping is proscribed. The assessment of fiduciary status on the part of a potential insider is a predicate to recognizing a protected agency law fiduciary or fiduciary-like duty. Accordingly, the earlier-described transaction costs arising from the unpredictability and uncertainty associated with identifying the predicate fiduciary or fiduciary-like duty are similarly and equally applicable here.[129]

Materiality and Other Measures of the Level of Significance of Nonpublic Information

Under general principles of insider trading law, an insider or tippee must trade while in possession of material, nonpublic information or a tipper must selectively disclose material, nonpublic information in order to violate the law. Although there are sometimes questions about whether a specified type of information is a "fact" or whether particular facts are public,[130] more significant questions typically arise as to whether particular facts are material. Edmund W. Kitch noted that "In the insider-trading context, materiality has to do with the bar against insiders profiting from inside information. It deals with the question: When has enough information been disclosed so that insiders are free to trade?"[131] Or, conversely, when is nonpublic information possessed while trading with others or used in tipping others important or significant enough that it will subject the insider trader or tipper and any tippees to liability?

Under U.S. insider trading law, a fact is material if it is substantially likely that a reasonable investor would find the fact important in making an investment decision or if it is substantially likely that a reasonable investor would find that revealing the fact will significantly alter the total mix of publicly available information.[132] Material information may comprise historical and speculative, contingent, or other forward-looking facts and may be quantitatively or qualitatively important or significant:[133]

> To violate insider-trading laws, the corporate insider must use *material*, nonpublic information. Information is material if there is a "substantial likelihood that a reasonable investor would consider it important in making an investment decision." . . . While speculative or "soft" information is often immaterial, courts have been reluctant to find it per se immaterial. This court . . . found that an uncertain stock price increase was material, even though speculative, because "it would have been considered important in making investment decisions."[134]

The materiality of speculative or contingent forward-looking facts is assessed using a specialized test:[135] "information about future events is material if—taking into account both the probability of those events and their potential

importance—a reasonable investor would regard the information as 'significantly' different from the information already made public."[136] Materiality is a mixed question of law and fact and is not generally deemed to be an appropriate subject for summary judgment.[137]

Japanese insider trading regulation approaches the subject of materiality in a somewhat more concrete fashion than U.S. law does, but the Japanese rule ends up being quite like the U.S. standard in substance. Specifically, the Japanese statute defines materiality (a "Material Fact Pertaining to Business or Other Matters") to include items on a listed set of facts, excluding any transaction or event (specified from among certain listed facts) "regarded under the criteria provided by a Cabinet Office Ordinance as one that may have only minor influence on investors' Investment Decisions."[138] Among the listed facts under the Japanese statutes are various transactions and events involving both the issuer and its subsidiaries, including certain expected categories of corporate finance transaction (e.g., securities offerings, business combination transactions, recapitalizations, buybacks, stock splits, dividends, dissolution), damages created by disaster, significant changes in shareholder composition, a change in position that could cause delisting or deregistration, significant changes in financial condition or results from operations, and "material facts concerning operation, business or property of the Listed Company, etc. that may have a significant influence on investors' Investment Decisions."[139] The list also may be enhanced in a certain limited respect by a Cabinet Order prescribing that certain occurrences are material.[140] Accordingly, contingent or speculative forward-looking information, for example, may be material under Japanese law even though the listed types of information generally reference an actual board decision to proceed with an action. As one legal scholar summarized,

> Japanese law attempts much greater specificity. The Japanese insider trading statute contains a laundry list of important facts that can trigger the insider trading prohibition. These include: management decisions about issuing securities, reductions in capital, stock splits, alterations in dividends, mergers, purchases or sales in whole or in part of a business, dissolution, and marketing a new product; disasters or damages to the corporation; changes in principal shareholders; events causing delisting of a security; differences between actual and forecasted sales and profits; any other events listed by Cabinet Ordinance; and, finally, other important facts involving the management, business or assets of the corporation which would materially affect investment decisions.[141]

Although the greater specificity in the Japanese statute offers more certainty in making certain materiality determinations, the potential for exclusions under Cabinet Office Ordinance criteria and the catchall category for transactions and events that may influence investor decision making may mean that the facial appearance of certainty is illusory.

Interestingly, the statute does restrict the catchall category to facts "concerning operation, business or property of the Listed Company, etc." Conversely, the materiality formulation under U.S. insider trading law is not restricted to corporate or corporate-related facts. In fact, U.S. legal scholars and the media have paid significant attention to the possibility that personal facts concerning executive officers of public companies also may be deemed material under Rule 10b-5.[142] Few countries have embraced the all-encompassing "importance test" reflected in the materiality standard applicable in U.S. insider trading cases or, for that matter, the arguably narrower "significant influence" test applicable to unlisted events under Japan's insider trading statute.[143] However, German insider trading regulation is apparently converging toward these materiality formulations.

German insider trading law defines materiality in the context of an overall definition of "inside information" (which also encompasses a definition of the nonpublic nature of inside information). Specifically, the statute provides that

> Inside information is any specific information about circumstances which are not public

> knowledge relating to one or more issuers of insider securities, or to the insider securities themselves, which, if it became publicly known, would likely have a significant effect on the stock exchange or market price of the insider security.[144]

The statute further offers that

> Specifically, inside information refers to information about circumstances which are not public knowledge . . . , which
>
> 1. is related to orders by third parties for the purchase or sale of financial instruments or
> 2. is related to derivatives . . . relating to commodities and which market participants would expect to receive in accordance with the accepted practice of the markets in question.[145]

This statutory definition expressly relies on market price effects as a primary determinant of materiality. Curiously, however, the statute goes on to offer that "Such a likelihood is deemed to exist if a reasonable investor would take the information into account for investment decisions."[146] This latter formulation or guidance was not in earlier versions of the statute[147] and brings the German formulation closer to the U.S. standard. Moreover, German law incorporates the concept that forward-looking information can be material by providing that, under the definition quoted above, "The term circumstances . . . also applies to cases which may reasonably be expected to come into existence in the future."[148]

However, the German statute is narrower than the U.S. formulation (and more similar to the language in the Japanese materiality catchall) in an important respect: It restricts the content of the information at issue to that "relating to one or more issuers of insider securities, or to the insider securities themselves."[149] Accordingly, although the relevant terms may be susceptible to broad interpretations, it may be harder to argue that nonpublic personal facts, for example, are inside information under the German insider trading law than it is to make the same argument under U.S. law.[150]

Under the insider trading regimes in each country—the United States, Japan, and Germany—insiders are not liable for trading while in possession of insignificant nonpublic information. Approaches to the determination of the requisite threshold level of informational materiality vary from country to country; yet under current insider trading rules, the approaches taken in the United States, Japan, and Germany converge to some extent around an investor-oriented perspective of the importance of information possessed by an insider (or other regulated person) at the time of a trade or shared by an insider in a tip.

Still, as this descriptive comparative analysis of insider trading laws suggests, subtle but important differences in materiality exist or, based on enforcement activity, may exist. For example, as noted above, U.S., Japanese, and German approaches to materiality apparently differ in substance on whether or to what extent personal information about a corporate executive may be material. The United States has a one-tiered test for materiality in this context that is alternatively expressed in two ways. Under U.S. law, there must be a substantial likelihood that the personal information would be important to the reasonable investor in deciding whether to buy or sell the issuer's securities or, stated in the alternative, there must be a substantial likelihood that disclosure of the personal information would significantly alter the total mix of information in the market.[151] One can imagine circumstances where personal information about a public company executive officer is (at least arguably) material.[152]

By contrast, Japan and Germany both apply a two-tiered test for materiality in the context of personal facts: A threshold test restricts substantive content (although the restrictions now may be less significant under German law) and a secondary test gauges importance or significance. The Japanese approach is, perhaps, the most narrow in this regard, in that the personal information must constitute "material facts concerning operation, business or property of the Listed Company, etc. that may have a significant influence on investors' Investment Decisions."[153]

German law requires that the personal information relate "to one or more issuers of insider securities, or to the insider securities themselves" and that the personal information "would likely have a significant effect on the stock exchange or market price of the insider security," which the likely effect is deemed to exist if "a reasonable investor would take the information into account for investment decisions."[154] As a threshold issue in Japan and Germany, it may be difficult for a public enforcement agent or (as applicable) a private litigant to establish that a personal fact meets the applicable content restrictions. Even assuming proof of the requisite content connection, one must also then successfully argue that the personal facts satisfy either the "significant influence" test (in Japan) or the modified "price-effect" test (in Germany). It is unclear from the face of the respective Japanese and German statutes how easy or difficult it may be to successfully make that argument. However, it appears to be easier to make the argument in the United States under the one-tiered test.

Although transaction costs associated with materiality determinations involving personal facts are likely to be high in all three countries profiled here, under most other circumstances, the relatively "open architecture" of the materiality concept under U.S. insider trading laws is likely to generate more transaction costs than the more well-defined approaches to determining materiality under Japanese and German insider trading law.[155] The elements of materiality in the United States, as a combined issue of law and fact, evolve incrementally as a matter of federal common law in response to specific cases brought before the federal courts. As a result, materiality determinations under U.S. law are fraught with uncertainty and unpredictability.[156] Although similar determinations made under Japanese and German insider trading law may not be certain or predictable, the more detailed, tailored statutes in these civil law states provide more guidance in the form of anchoring concepts (in Japan, a list of material events and transactions, and in Germany, a focus on significant market price effects), thereby enhancing the prospects for certain and predictable results and limiting transaction costs incurred by transaction and litigation planners.

The Distinctive Requirement of Scienter in the United States

Under U.S. insider trading law, an insider who breaches a fiduciary duty by trading in a corporation's securities while in possession of material, nonpublic information or by tipping material, nonpublic information is not violating the law unless the insider acts with scienter—a state of mind that involves an awareness of the propensity to deceive investors and at least a reckless (and certainly an intentional) disregard of the probability that the actions taken will result in investor deception.[157] Similarly, a tippee of material, nonpublic information is not liable absent scienter.[158] This element of unlawful insider trading in the United States emanates from the nature of insider trading regulation in the United States as a type of securities fraud. The deception necessary to find illegal insider trading as fraudulent conduct under Section 10(b) and Rule 10b-5 requires some level of intentional conduct, at least as construed by the U.S. Supreme Court.[159] Although the SEC adopted a rule in 2000—Rule 10b5–1[160]—that many believe changes the nature of the scienter requirement (making it a weaker requirement), this rule has not been tested at the margins at the Supreme Court level.[161] The meaning of Rule 10b5–1 is, in fact, quite unclear.[162]

Because insider trading regulation in Japan and Germany is not based in the law of fraud, there is no equivalent requirement for a state of mind in either state's statutes. Both Japanese and German law is violated if an insider who possessed material, nonpublic information trades or discloses that information before it is publicly disseminated, regardless of that insider's state of mind.[163]

The scienter requirement may be the largest difference among the three states' laws—and the biggest difference between U.S. insider trading regulation and insider trading regulation in the

rest of the world. Substantively, the scienter requirement makes it less likely that an insider trader or tipper, or an insider's tippee, will be held liable for violating the insider trading prohibitions under Section 10(b) and Rule 10b-5. Scienter represents an additional requirement for the Department of Justice, SEC, and private plaintiffs to meet, and it is difficult to prove in the absence of a clear statement or clear conduct establishing the actor's intent (although perhaps less so after the adoption of Rule 10b5–1). Accordingly, the scienter requirement narrows the scope of potential liability under U.S. law in relation to the laws of Japan and Germany, where, absent scienter, facts would support liability under the laws of all three countries, whereas scienter may excuse an insider from liability in the United States.

Difficulties in defining and proving scienter increase uncertainty and unpredictability in insider trading enforcement in the United States. The definitional issues will be explored and, no doubt, settled through federal court decisions over time, but the proof issues will remain. In each case, however, the scienter requirement adds transaction costs to the U.S. insider trading compliance and enforcement systems. These costs are not present in the Japanese and German regulatory schemes.

Fairness as a Way of Understanding Insider Trading Regulation

Although there are common origins of and bases for insider trading regulation in different states, there also are significant differences among state insider trading prohibitions. It is one thing to describe these similarities and differences and how they operate; it is another thing altogether to understand them in a way that enables optimal regulation in a global market. This part of the chapter looks at comparative insider trading regulation through a fairness lens in an effort to better understand, and an attempt to bridge, the differences among state laws governing insider trading. As an outlier, the United States is our starting point and our comparative base.

The U.S. Supreme Court is credited with overruling fairness as a defining policy basis for U.S. insider trading regulation in the *Chiarella* and *Dirks* cases,[164] but it is possible to view the Court's decisions in *Chiarella* and *Dirks* as merely focusing on a different conception of fairness. A number of scholars have approached the analysis of U.S. insider trading principles from this angle. Professor Kimberly Krawiec, for example, cogently described current U.S. insider trading regulation from a fairness standpoint:

> Insider trading law currently attempts to draw the line between legal and illegal informational advantages by reference to breach of a fiduciary duty. Because the gathering of information through a fiduciary breach is not considered socially productive behavior, there is no identifiable romantic author whose diligence and effort must be rewarded through permission to profit from such informational advantages. Information gained through a fiduciary breach, therefore, is considered part of the public sphere and, along with other public sphere privileges, such as access to the criminal justice system or the right to vote, must be shared equally among marketplace participants. This egalitarian goal is accomplished by forcing those in possession of secret knowledge attained through a fiduciary breach to disclose that information prior to trading. By contrast, nonpublic information gained through means other than a fiduciary breach is considered socially useful research that must be rewarded by permitting the information possessor to profit from her superior trading knowledge. Such information, therefore, is subconsciously delegated to the private sphere where, along with other private sphere resources, such as wealth, experience, or education, equality is not expected. Consequently, those in possession of material nonpublic information attained through means other than a fiduciary breach are permitted to trade on that information without disclosure to their trading partners.[165]

We may say, then, that U.S. insider trading regulation attempts to be fair to both those trading

in the market without the benefit of material, nonpublic information and to those who acquire material, nonpublic information in a socially productive way.

In legal scholarship, another, more egalitarian form of fairness in insider trading regulation has been termed "level playing field" fairness, and the equal access informational fairness at the root of most insider trading regulation may be described in those terms.[166] Japan's insider trading rules, for example, were designed to promote this type of fairness. The fairness of an equal access principle can be explained in a manner similar to that used to explain the fairness of the fiduciary duty rule in the United States:

> equality of access advocates maintain that informational advantages that cannot be lawfully eroded through the expenditure of sufficient time and effort should be prohibited. . . . [i]nformational advantages that cannot be lawfully eroded through the expenditure of sufficient time and effort, such as, for example, the informational advantages possessed by a corporate insider or misappropriator, are not considered socially useful research. . . . Such information, therefore, is part of the public sphere and must be shared with other securities traders before the information possessor is permitted to exploit her informational advantage through securities trading. Consequently, trading based on informational advantages that cannot be lawfully eroded would be prohibited under an equality of access approach to insider trading regulation. Equality of access advocates contend with the informational advantages enjoyed by market professionals by arguing that, although every investor does not have the opportunity to become a corporate insider or misappropriator or a tippee of an insider or misappropriator, every investor could purchase the services of an investment analyst. Investment analysts, market makers, exchange members, and others who are assumed to provide socially useful research are thus romantic authors whose beneficial behavior must be rewarded though permission to profit from their informational advantages. Information attained through the research of such parties, therefore, is considered part of the private sphere and can be freely exploited in the pursuit of trading profits.[167]

Japan's insider trading rules attempt to provide equal access by identifying and regulating the conduct of those who have advantaged access to material, nonpublic information. Japanese insider trading regulation does not, however, provide for comprehensive equal access, in that it (1) may not accurately and completely identify those with privileged access to material, nonpublic information, (2) allows insiders to personally benefit from tipping (punishing only the tippee), (3) permits misappropriators to trade for personal benefit, and (4) embodies a narrow definition of material, nonpublic information. Each of these aspects of the Japanese insider trading regime may enable traders or tippers with privileged informational access to benefit from that privilege at the expense of other market participants.

Although the fiduciary duty rationale that operates in the United States and the equal access rationale exemplified in Japan each express a different—but equally valid—conception of fairness in insider trading regulation, neither helps the investor who believes that she is being treated inequitably because others in the market have an information advantage over her.[168] Some analysts have noted that "A broader 'fairness' objection to insider trading . . . regards the trade as unfair—and dishonest—based upon the simple unavailability of inside information to all parties. . . . The other party's decision to consent arises from information of which he is aware, not from information that is merely available to him."[169] This fairness objection is known as the parity of information rationale and is the policy that underlies the German insider trading statute. It is the most helpful conception of fairness to the disadvantaged investor and the easiest type of fairness to explain. Here, equity is based not on an equal access to or availability of information but, rather, on an equal awareness of information. German insider

trading law exemplifies this policy in that all possessors of material, nonpublic information are restricted from trading and tipping, regardless of whether they have preferential access to that information.

How do these three insider trading regimes correspond with larger, more universal notions of fairness, outside the realm of insider trading regulation? U.S. insider trading regulation and Japanese insider trading regulation do comport well with a Rawlsian conception of fairness. According to Rawls, insider trading regulation is fair if it (1) allows for equality of opportunity and (2) provides the greatest benefit to those least advantaged. These are the two components, as you will recall, of the second principle of justice.[170] Rawls admitted, however, that "Whether the aims of the second principle are realized is . . . difficult to ascertain. To some degree, these matters are always open to reasonable differences of opinion; they depend on inference and judgment in assessing complex social and economic information."[171]

Distinctions based on fiduciary or fiduciary-like duties (including the related definition of an insider) or based on advantaged access to information provide some foundation for a claim that the "disclose or abstain" rule provides equal opportunity. If a person with a duty of trust and confidence (in the United States) or a statutory insider (in Japan) possesses nonpublic information that is significantly likely to be important to a reasonable investor, then he must disclose it before trading (or uncomfortably rely on a lack of scienter as a defense); if anyone else possesses the same type of information, the information must have been available to all for the taking, even if only some are lucky or smart enough to have acquired it. Broad materiality standards like those operating under U.S. law accentuate equal opportunity by enlarging the scope of information that must be disclosed before trading may be undertaken. Yet, Rawls noted that it is not enough that opportunities are available to all; rather, it should also be true that "all should have a fair chance to attain them."[172] Fiduciary or fiduciary-like relationships and corporate or other positions creating unequal access to information are not fairly attainable by all, evidencing a lack of equal opportunity.

Insider trading regulation based on a parity of information, by its very essence, provides investors with equal opportunity in the market. We can say that German insider trading regulation, which is based on information equality, affords equal opportunity to all potential market participants because each is treated in exactly the same way. Unless everyone in the market possesses the same material information that an individual trader has, the individual trader must abstain from trading or tipping others.

Assuming that equal opportunity exists, insider trading regulation may not always supply the greatest benefit to the least advantaged. Even if we view U.S. insider trading law as providing equal opportunity to those seeking material information, for example, allowing insiders without scienter to use material, nonpublic information in breach of a duty of trust and confidence appears to weight the regulatory system toward insiders—those advantaged by their informational access. Those who have greater access to material, nonpublic information are permitted under U.S. law to use it negligently to their own advantage. Moreover, U.S. and Japanese insider trading regulation may be faulted for not providing the greatest benefits to the least advantaged because both U.S. and Japanese law allow those who have advantaged access to information (but are not regulated as insiders, tippees, or misappropriators) to trade for personal benefit to the disadvantage of other traders in the market.[173] Japanese insider trading law is, however, on its face, better than U.S. insider trading law at allocating benefits to the least advantaged market participants in that its definition of insiders is specifically designed to include those who are advantaged in their access to material, nonpublic information. In defining insider status by reference to a duty of trust and confidence, U.S. insider trading regulation may be both over- and underinclusive as a measure of those who are advantaged in their access to

material, nonpublic information. Yet in both the United States and Japan, investors without practical access to material, nonpublic information, as the least advantaged market participants in the insider trading analysis, may not be afforded the greatest benefit. Conversely, informationally disadvantaged investors who can, through effort or expense, obtain material, nonpublic information remain incentivized to do so, and trading through these entrepreneurial investors would increase available information in the market, thus making market prices more efficient.

Insider trading regulation based on equal information does appear to provide the greatest benefit to the least advantaged. By taking trading and tipping benefits away from those in the market with informational advantages, German insider trading law unambiguously reallocates inequities in the market toward those with no information. In doing so, however, German insider trading law removes any incentive on the part of informationally disadvantaged investors to increase their wealth and market efficiency by expending time and money to acquire material, nonpublic information and use it in trading. Because Rawls's framework does not demand formal equality and desires to preserve, to the extent possible, benefits inuring to those who work for them, this disincentive makes us think hard about the fairness of informational parity as a basis for insider trading regulation.

Nevertheless, German law most closely resembles the Rawlsian notion of fairness in regulation. It is the regulatory system that investors would most frequently choose from behind the veil of ignorance—without knowing whether they would be, in a particular circumstance, advantaged or disadvantaged (although Rawls does not apparently intend that legislative determinations, as opposed to agreement on principles applicable to those judgments, be made from behind the veil of ignorance). This is true notwithstanding potential informational efficiencies created through trades made by the best-informed investors. Fairness of price cannot be assessed in isolation or to the exclusion of fairness of position and outcome.

Recall now the two alternative non-Rawlsian notions of fairness mentioned earlier in the essay—one that assesses fairness based on a balancing of individual interests for the good of society as a whole and one that assesses fairness based on the equal or equitable treatment of individuals.[174] How do insider trading regimes stack up under these two notions of fairness?

As outlined in this essay and described by Professor Krawiec, U.S. insider trading regulation does attempt to balance individual interests—those of insiders (traders and tippers), tippees, and misappropriators (in each case, with and without scienter) as well as those of actual and prospective investors—for greater societal good. However, U.S. insider trading law does not provide for equal treatment of market participants. Among other things, U.S. insider trading law permits unequal access to and use of material, nonpublic information by nonfiduciaries that have privileged access to information, and it permits insiders, tippees, and misappropriators without scienter to trade or tip (as applicable) without having to publish and disseminate the material, nonpublic information they possess.

Japanese insider trading regulation has similar attributes in these respects. Japan's legal rules endeavor to balance the interests of multiple investor constituencies (statutory insiders and other actual and prospective investors), although we may question the judgments made in the failure of these rules to regulate, for example, tippers and misappropriators. Moreover, Japanese insider trading regulation does not achieve equal treatment. Noninsiders, tippers, and misappropriators are all free to reap personal benefits from their access to material, nonpublic information.

Conversely, German insider trading rules represent a less clear balancing of interests for the greater good of society. Little, if any, value appears to be placed on entrepreneurial efforts to acquire material, nonpublic information to enhance individual wealth and improve market price efficiencies. However, as previously observed, German law does come the closest to

achieving equal treatment by valuing information equality in securities trading.

Conclusion

The insider trading rules of various states have both core similarities and important differences. A fairness analysis of these laws exposes the various implications of these extant similarities and differences. U.S., Japanese, and German insider trading regulation, as three exemplars, embody different conceptions of fairness, each likely emanating from both culture and context.[175]

Understanding these regulatory differences in a fairness context provides important information to those who desire to effectuate meaningful international insider trading regulation. Effective international insider trading regulation will require consensus around the type of fairness that the regulatory scheme should be designed to achieve as well as, for example, agreement on and implementation of effectual enforcement. This represents an enormous—perhaps even insurmountable—challenge for lawmakers with different cultural and contextual backgrounds.

Rawls's work is relevant here, too. In *The Law of Peoples*, Rawls posited that eight key principles, determined from the original position (behind the veil of ignorance), govern an international effort to achieve a fair cooperative society.[176] If there is agreement on these foundational principles among people with different cultures who have experienced life under different circumstances, then there is hope for an eventual agreement on a unifying conception of fairness that would enable the construction and implementation of international insider trading regulation.

NOTES

1. Notably, Henry Manne is among many law and economics scholars that decry fairness as a policy underpinning for insider trading regulation. *See*, *e.g.*, HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). This essay does not engage the debate over fairness policy in insider trading regulation (although brief reference is made to market efficiencies); rather, it uses conceptions of fairness as a sorting device for the substantive outcomes of different insider trading regimes.

2. International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, at 5 (May 2003), *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf ("Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets.").

3. Jeffrey L. Dunoff, *Fairness in the World Economy: US Perspectives on International Trade Relations*, 101 AM. J. INT'L. L. 907, 908 (2007) (Book Review) ("Fairness is a multifaceted concept with many dimensions and many meanings."). Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L. J. 353, 360 (1988).

4. *Id.*; *see also* Judith G. Greenberg, *Insider Trading and Family Values*, 4 WM & MARY J. OF WOMEN & L. 303, 349 (1998) ("The legitimacy of market transactions depends on the assumption that the parties have freely and voluntarily agreed.").

5. *See* BLACK'S LAW DICTIONARY 560 (Bryan A. Garner ed., 7th ed. 1999) (defining "equity" as "fairness, impartiality," among other things).

6. Merriam-Webster Online Dictionary, May 18, 2010, *available at* www.merriam-webster.com/dictionary/fair.

7. *See*, *e.g.*, JOHN RAWLS, JUSTICE AS FAIRNESS 4–5 (Erin Kelly ed., 2001).

8. *See*, *e.g.*, *id.* at 7–8.

9. *Id.* at 18–19.

10. *Id.* at 19.

11. *Id.*

12. *Id.* at 85–89.

13. *Id.* at 88 ("[T]he veil of ignorance prevents the parties from knowing the (comprehensive) doctrines and conceptions of the good of the persons they represent.").

14. *Id.* at 87.

15. *Id.* at 42–43. The principles are applied in an ordered fashion; "the first principle is prior to the second; also, in the second principle fair equality of opportunity is prior to the difference principle." *Id.* at. 43.

16. *Id.* at 48.

17. Robert G. Bone, *Agreeing to Fair Process: The Problem with Contractarian Theories of Procedural Fairness*, 83 B.U.L. REV. 485, 495 (2003).

18. 17 C.F.R. § 240.10b-5 (2010). Rule 10b-5 was adopted by the U.S. Securities and Exchange Commission under Section 10(b) of the Securities Exchange Act of 1934, as amended. 15 U.S.C. § 78j(b) (2007).

19. *See* Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 233 (1998) ("[A] growing number of countries have adopted laws which preclude insider trading, originally at the behest of the SEC and today largely under the auspices of IOSCO."); George C. Nnona, *International Insider Trading: Reassessing the*

Propriety and Feasibility of the U.S. Regulatory Approach, 27 N.C. J. INT'L L. & COM. REG. 185, 201 (2001) ("The SEC has . . . exported U.S. insider trading laws to other jurisdictions, as part of the crusade to stem insider trading globally.").

20. *Id.*; Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 837 (2006) ("Within roughly the past fifteen years, EU members, Japan, China, and other countries have prohibited insider trading in similar circumstances and on substantially the same grounds as the United States.").

21. *E.g.*, Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 666 (2001) ("Not surprisingly, other jurisdictions soundly have rejected the U.S. fiduciary relationship (or relationship of trust and confidence) model to define the scope of illegal insider trading and tipping."); *id.* at 664 ("[C]ontrary to the U.S. definition, the concept of materiality is connected to the information's impact on market price.").

22. *Chiarella v. United States*, 445 U.S. 222, 231–35 (1980); *see* Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 AM. J. COMP. L. 123, 124 (2006) ("The fiduciary theory animates to a considerable degree the U.S. federal law against insider trading."); Dimity Kingsford Smith, *The Same Yet Different: Australian and United States Online Investing Regulation*, 37 U. TOL. L. REV. 461, 493 n.222 (2006) (noting Australia's deviation from the fiduciary rationale used in the United States in favor of "an information parity or market fairness approach").

23. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (identifying those subject to misappropriation liability for insider trading by reference to "breach of a duty owed to the source of the information"—"a duty of loyalty and confidentiality"); *Dirks v. SEC*, 463 U.S. 646, 664 (1983) (noting that tippee liability depends on a predicate breach of duty by the tipper/insider); *Chiarella*, 445 U.S. at 230 (classifying those with "a relationship of trust and confidence"—those "who have an obligation to place the shareholder's welfare before their own"—as classical insiders); *see* Eric Engle, *The EU Means Business: A Survey of Legal Challenges and Opportunities in the New Europe*, 4 DEPAUL BUS. & COMM. L.J. 351, 370–71 (2006) (noting the more concrete, functional-role definition under the 1989 and 2003 European Union insider trading directives); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1134 n.11 (2003) (summarizing the U.S. conception of an insider).

24. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *see* Heminway, *supra* note 23, at 1158–60 (describing the status of a "market effect" test under U.S. insider trading law).

25. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). *See* Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart That Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 13 (2006) ("Defining scienter with respect to insider trading has been controversial, with courts and the SEC disagreeing about whether it must be shown that the defendant 'used' the inside information to profit (i.e., that he traded because of the information) or whether mere possession of the information is enough, without regard to motivation.").

26. Insider trading also is regulated by and under Section 16(b) of the 1934 Act. 15 U.S.C. § 78p(b) (2007). In addition, Rule 14e-3 regulates insider trading in connection with tender offers. 17 C.F.R § 240.14e-3 (2010). Further, disclosures made to brokers, dealers, investment advisers, investment companies, and other specified potential securities traders are addressed under Regulation FD. 17 C.F.R. § 243.100–03 (2010). Although these regulatory provisions relate to the insider trading prohibitions under Section 10(b) and Rule 10b-5, the elements of each rule and the remedies provided, among other things, differ from those under Section 10(b) and Rule 10b-5. Accordingly, these other related rules are not addressed in this chapter.

27. 17 C.F.R. § 240.10b-5 (2010).

28. *See* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 86 (1998) ("The complete failure to disclose that a buyer or seller of securities is in possession of material nonpublic information is not generally viewed as a violation of subsection (b) of Rule 10b-5, which relates only to the making of untrue or misleading statements. Rather, such inaction can be interpreted as 'a device, scheme or artifice to defraud' in violation of subsection (a) or as an 'act, practice or course of business which operates as a fraud or deceit' upon a third person in violation of subsection (c)."); *see also* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323 (2009) (explaining how silence can constitute fraud by deception under Rule 10b-5).

29. 15 U.S.C. § 78j(b) (2007).

30. *Id.*

31. *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828–29 (D. Del. 1951) (footnote and citation omitted). In an earlier case, the U.S. District Court for the District of Pennsylvania found that, "Under any reasonably liberal construction, these provisions [Section 10(b) and Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction." *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (D. Pa.

1947). And in an even earlier administrative action, the SEC similarly concluded that "there was a clear necessity, in order not to take unfair advantage of shareholders, for the issuer and those in control to make timely disclosure of the identity of the purchaser, of improved financial and operating condition of the issuer, and of the full terms of the transfer to Salta of the Truck Corporation's business and of its liquidation. . . . It is our opinion that the purchase of the securities under the circumstances set forth herein unaccompanied by appropriate disclosure of material facts constituted a violation of Rule X-10B-5." *In re* The Purchase and Retirement of Ward La France Truck Corporation Class "A" and Class "B" Stocks, 13 S.E.C. 373, 381 (1943).

32. Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L L. 63, 71 (2002) (noting that after the 1942 adoption of Rule 10b-5, "Nearly two decades passed before anyone applied Rule 10b-5 to trading on undisclosed inside information.").

33. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

34. *Id.*

35. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (endorsing these alternative standards for materiality).

36. *SEC v. Texas Gulf Sulphur,* 401 F.2d 833, 854 (2d Cir. 1968), *cert, denied,* 394 U.S. 976 (1969).

37. *Id.* at 848 ("[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.").

38. *Id.*; *In re* Cady, Roberts & Co., 40 S.E.C. at 912; *see also supra* note 31.

39. *Chiarella v. United States*, 445 U.S. 222 (1980).

40. *Id.* at 228.

41. *Dirks v. SEC*, 463 U.S. 646 (1983).

42. *Id.* at 660.

43. *Id.* at 659–64; *see also* David T. Cohen, Note: *Old Rule, New Theory: Revising the Personal Benefit Requirement for Tipper/Tippee Liability under the Misappropriation Theory of Insider Trading*, 47 B.C. L. REV. 547, 549–50 (2006); Masanori Hayashi, Note: *Japanese Insider Trading Law at the Advent of the Digital Age: New Challenges Raised by Internet and Communication Technology*, 23 HASTINGS COMM. & ENT. L. J. 157, 165 (2000) ("Under U.S. law, an insider is liable for tipping material nonpublic information if he anticipates some personal benefit from the disclosure. Tippees can be held liable if the tipper breached a duty and the tippee knew that the tipper was breaching the duty." (footnote omitted)).

44. Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 211–16 (2005/2006) (outlining the liability of "remote tippees" under U.S. insider trading law); *id.* at 227 (noting that under the Insider Trading & Securities Enforcement Act of 1988, "primary tippers are liable for remote tippee trades in actions brought by the government, but are relieved of liability to private plaintiffs for remote tippee trades."); Hayashi, *supra* note 43, at 165 ("Presumably, the duty to abstain or disclose could be passed down a chain of tippees indefinitely, and individual liability could be attached to each who breached that duty.").

45. *United States v. O'Hagan*, 521 U.S. 642 (1997).

46. *Id.* at 652–53.

47. *Id.* at 652.

48. 17 C.F.R. § 240.10b5–1 (2010).

49. Linda Chatman Thomsen, Testimony Concerning Insider Trading, Sept. 26, 2006 (before the U.S. Senate Committee on the Judiciary), *available at* http://sec.gov/news/testimony/2006/ts092606lct.htm.

50. Shen-Shin Lu, *Are the 1988 Amendments to Japanese Securities Regulation Law Effective Deterrents to Insider Trading?* 1991 COLUM. BUS. L. REV. 179, 181–83 (tracing the pre-1988 development of the Japanese securities laws); Sadakazu Osaki, *The Evolution of Insider Trading Regulations in Japan*, *in* INSIDER TRADING: GLOBAL DEVELOPMENTS AND ANALYSIS 144 (Paul U. Ali & Greg N. Gregoriou eds., 2009); Larry Zoglin, *Insider Trading in Japan: A Challenge to the Integration of the Japanese Equity Market into the Global Securities Market*, 1987 COLUM. BUS. L. REV. 419, 420 (1987) ("Japan's securities law, adopted in 1948, was modeled upon American securities statutes.").

51. *See* Lu, *supra* note 50, at 186 ("Old Article 58 was a copy of Rule 10b-5 of the American Securities Exchange Act of 1934. Rule 10b-5 is a catchall fraud provision in federal securities regulations, and it has been widely used against insider trading in the United States. In contrast to Rule 10b-5, old Article 58 was rarely used in Japan and was never used in an insider trading case."); Osaki, *supra* note 50, at 145; Note: *The Regulation of Insider Trading in Japan: Introducing a Private Right of Action*, 73 WASH. U. L. Q. 1399, 1409 (1995) ("While the U.S. anti-fraud provision, section 10(b), became the most effective weapon against insider trading, the Ministry of Finance considered its equivalent, article 58, 'too vague' to apply.").

52. Lu, *supra* note 50, at 186–88.

53. Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855, 1890 (1997) ("The United States, for example, through the 1980s and into the 1990s, . . . pursued an active effort to obtain agreements from several different countries to impose an insider trading regime similar to the one in place in the United States. As a result of this pressure, several countries, including Japan have instituted similar regimes."); Lu, *supra* note 50, at 193–94 (describing the impetus for insider trading initiatives in a number of

countries in the late 1980s); Osaki, *supra* note 50, at 145–46; Ramzi Nasser, *The Morality of Insider Trading in the United States and Abroad*, 52 OKLA. L. REV. 377, 381 (1999) ("Based on domestic and foreign criticism of rampant unpunished insider trading, Japan amended its insider trading laws in 1988."); *see also* Lu, *supra* note 50, at 185 (noting and describing the 1988 amendments).

54. *See* Lu, *supra* note 50, at 195–97; Osaki, *supra* note 50, at 145.

55. James A. Kehoe, *Exporting Insider Trading Laws: The Enforcement of U.S. Insider Trading Laws Internationally*, 9 EMORY INT'L L. REV. 345, 355 (1995).

56. Financial Instruments and Exchange Act, art. 166(1), Apr. 1, 2008, *available at* www.fsa.go.jp/common/law/fie01.pdf.

57. Financial Instruments and Exchange Act, art. 166(3), Apr. 1, 2008, *available at* www.fsa.go.jp/common/law/fie01.pdf; *see also* Gevurtz, *supra* note 32, at 83–84 ("Under Japanese law, persons receiving non-public information directly from corporate related parties are subject to the prohibition on trading."); Hayashi, *supra* note 43, at 165 ("Under Japanese law, the tipping rule provides that no person to whom an insider has communicated a material fact may trade on that company's stock until the information has been publicly disclosed.").

58. *See* Coles, *supra* note 44, at 227 ("In Japan, for example, the prohibition on inside trading extends only to someone who receives nonpublic information directly from a party related to the corporation."); Gevurtz, *supra* note 32, at 84 ("[U]nlike the United States' law (or the EU Directive), the Japanese prohibition only extends to a person who receives information directly from a corporate related party, and not to remote tippees."); Hayashi, *supra* note 43, at 165–66 ("[T]he possibility that liability can be extended to those removed from the original 'source' of information under U.S. law can be contrasted with a mere 'direct communication' standard under Japanese law.").

59. Lu, *supra* note 50, at 185 ("There are numerous insider trading cases in the United States, while in Japan the figure is near zero."); *id.* at 193 (reporting in 1991 that "In the United States there are up to forty insider trading cases every year. But in Japan, although Tokyo has become the world's largest securities market, there have been practically no insider trading cases in forty years.").

60. Nasser, *supra* note 53, at 382 (summarizing Japanese enforcement of insider trading in the 1990s); Osaki, *supra* note 50, at 150–52; Richard G. Small, *Towards a Theory of Contextual Transplants*, 19 EMORY INT'L L. REV. 1431, 1455 n.5 (2005) ("Although in 1988, as a result of a domestic scandal and overseas pressure, the prohibition was amended, few cases were brought until the mid-1990s.").

61. Enrico Colombatto & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV. 925, 952 (1996) ("Japan stepped up enforcement of its previously ignored insider trading regulations due to the United States's pressure.").

62. Kehoe, *supra* note 55, at 375.

63. *See* Osaki, *supra* note 50, at 152–54 (describing a recent case and the adoption and operation of the civil fine system).

64. *Id.* at 153.

65. *Id.* at 153–54.

66. *See Japan to double fines for insider trading*, JAPAN WEEKLY MONITOR, Jun. 9, 2008.

67. Joseph Blum, *The Regulation of Insider Trading in Germany: Who's Afraid of Self-Restraint?* 7 NW. J. INT'L L. & BUS. 507, 516 (1986) ("[T]the German authorities opted for a unique system mixing voluntary compliance with self-regulation."); James H. Freis, Jr., *An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland*, 19 B.C. INT'L & COMP. L. REV. 1, 30 (1996); Stephen J. Leacock, *In Search of a Giant Leap: Curtailing Insider Trading in International Securities Markets by the Reform of Insider Trading Laws under European Union Council Directive 89/592*, 3 TULSA J. COMP. & INT'L L. 51, 61–62 (1995); Peter M. Memminger, *The New German Insider Law: Introduction and Discussion in Relation to United States Securities Law*, 11 FLA. J. INT'L L. 189, 192 (1996); Victor F. Calaba, Comment: *The Insiders: A Look at the Comprehensive and Potentially Unnecessary Regulatory Approaches to Insider Trading in Germany and the United States, Including the SEC's Newly Effective Rules 10b5–1 and 10b5–2*, 23 LOY. L.A. INT'L & COMP. L. REV. 457, 468–9 (2001); Ursula C. Pfeil, Note and Comment: *Finanzplatz Deutschland: Germany Enacts Insider Trading Legislation*, 11 AM. U. J. INT'L L. & POL'Y 137, 140–43 (1996).

68. Blum, *supra* note 67, at 524 ("In sum, the German Insider Trading Guidelines can be characterized, in the words of University of Munich Professor Doctor Michael Will, as a 'toothless device.'"); Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. CIN. L. REV. 1133, 1150 (1998) ("Germany had relied on a voluntary code of conduct which was wholly ineffective."); Memminger, *supra* note 67, at 192–93 ("The Guidelines were generally regarded as quite ineffective, since they neither had the legal authority of an enacted law, nor were they accepted by courts as trade practice.").

69. Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. LAW 555, 582–83 (2000) ("In 1994, Germany enacted a national law to deal with this problem known as the *Wertpapierhandelsgesetz* (Security Trading Act). Under this

act, insider trading is a criminal offense punishable by fines or imprisonment up to five years."); Colombatto & Macey, *supra* note 61, at 945 ("Even more striking is the fact that in June 1994 the German Parliament authorized legislation making insider trading a crime for the first time in that country's history."); Freis, *supra* note 67, at 4–5, 40 (noting the adoption and effectiveness of criminal insider trading legislation in Germany); Karmel, *supra* note 68, at 1149–50 ("On August 1, 1994, Germany took a step toward aggressively competing in the international financial arena when it finally outlawed insider trading."); Memminger, *supra* note 67, at 192 ("On July 26, 1994, the German parliament adopted the Second Financial Market Promotion Law (*Zweites Finanzmarktförderungsgesetz*). . . . With its enactment, the German legislature began to regulate insider trading for the first time in German history."); Pfiel, *supra* note 67, at 137, 152 (noting the adoption and effectiveness of German criminal insider trading sanctions).

70. Calaba, *supra* note 67, at 470; Karmel, *supra* note 68, at 1150; Pfiel, *supra* note 67, at 149.

71. Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSPECTIVES 117, 136, 137 (2007).

72. Colombatto & Macey, *supra* note 61, at 952; Karmel, *supra* note 68, at 1167; Daniel James Standen, *Insider Trading Reforms Sweep across Germany: Bracing for the Cold Winds of Change*, 36 HARV. INT'L L. J. 177, 200 (1995).

73. Pfeil, *supra* note 67, at 144.

74. As one contemporaneous commentator summarized, "Germany . . . finally recognized the need for some form of insider-trading legislation in order to build a competitive international financial sector, despite its formerly vigorous opposition to EU proposals for banning insider trading by legal means. This recognition followed a relatively sharp decline in the German capital markets index. This accompanied a correspondingly significant decline in foreign investor confidence in the German market due to the highly publicized insider-trading scandal involving Germany's largest banking interest, Deutsche Bank. Foreign perceptions of the German economy had become the 'pivotal factor in the movement of share prices,' and apprehension over insider trading and interest rates had lowered the stock market index." Leacock, *supra* note 67, at 54 (footnotes omitted).

75. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 14, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start.

76. *Id.*; *see also* Freis, *supra* note 67, at 41; Karmel, *supra* note 68, at 1150–51 (explaining prohibited conduct); Memminger, *supra* note 67, at 215–26 (same).

77. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 14, Sept. 9, 1998 (last amended Jan. 1, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start; *see also* Freis, *supra* note 67, at 42 ("The duty to carry out these provisions rests upon the Federal Securities Trading Supervisory Authority. This entity is an independent federal superior agency within the competence of the Federal Ministry of Finance."); Gary L. Gassman & Perry S. Granof, *Global Issues Affecting Securities Claims at the Beginning of the Twenty-First Century*, 43 TORT & INS. L. J. 85 ("Germany formed the *Bundesanstalt fur Finanzdienstleistungsaufsicht* (*BaFin*) in 2002 to regulate and oversee banking, securities, and insurance services. By instituting proceedings as 'administrative matters,' BaFin enforces German statutes and regulations regarding insider trading, market and price manipulation, corporate disclosures, directors' conduct, and the like."); Karmel, *supra* note 68, at 1150 ("The newly created Federal Supervisory Authority for Securities Trading (FSA), is somewhat similar to the SEC. It is a federal agency under the Federal Ministry of Finance."); Pfiel, *supra* note 67, at 165 ("The German Parliament delegated the principal power for enforcing Germany's Insider Trading Law to the newly-created Federal Supervisory Office for Securities Trading (Federal Supervisory Office). The Federal Supervisory Office is a self-funding, independent government agency within the jurisdiction of the Federal Ministry of Finance." (footnotes omitted)); Anupama J. Naidu, Comment: *Was Its Bite Worse Than Its Bark? The Costs Sarbanes-Oxley Imposes On German Issuers May Translate into Costs to the United States*, 18 EMORY INT'L L. REV. 271, 299 (2004) ("Currently, regulation at the federal level is conducted by the Federal Securities Trading Supervisory Office, known in Germany as the BAWe. The BAWe is responsible for investigations of insider trading, protection of investors, improvements to market transparency, and cooperation on the international level." (footnotes omitted)).

78. Pfiel, *supra* note 67, at 164 (footnote omitted); *see also* Securities Trading Act (Gesetz über den *Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 14, Sept. 9, 1998 (last amended Jan. 1, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start; Freis, *supra* note 67, at 42–43 ("Additionally, a Securities Council (*Wertpapierrat*), composed of representatives of the *Lander* and other federal agencies, shall assist the Securities Trading Supervisory Authority in its supervision. The Authority shall work together with other German regulatory agencies responsible for banking and insurance regulation, the German Bundesbank, and the stock exchange supervisory authorities of

the *Lander*"); Pfiel, *supra* note 67, at 173 (describing the operation of the components of the regulatory structure).

79. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 837 (2006) ("By the turn of the millennium, virtually all developed nations had enacted U.S.-style insider trading laws and enforcement actions in the United Kingdom, France, Germany, China, Japan, South Korea, and elsewhere were no longer rare.").

80. George C. Nnona, *International Insider Trading: Reassessing the Propriety and Feasibility of the U.S. Regulatory Approach*, 27 N.C.J. INT'L L. & COM. REG. 185, 214–15 (2001); *see also* Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 33 (2002) ("The SEC has pressured Japan and Switzerland, for instance, to develop insider-trading regimes similar to that in place in the U.S. Similarly, the SEC 'made its disapproval of [Germany's] current system known both directly and indirectly through the prosecution of high-profile cases that violate United States insider trading laws.'" (footnote omitted)).

81. Colombatto & Macey, *supra* note 61, at 945 ("As recently as the mid-1980s, actual enforcement of insider trading regulations was largely confined to the United States. Most other major financial center nations either did not have insider trading regulation (e.g., Germany) or, if they did, did not actively enforce the regulations (e.g., Japan).").

82. Prentice, *supra* note 79, at 834.

83. *See also* Licht, *supra* note 19, at 233 ("Insider trading is another area where one observes a convergence trend towards a common rule. . . . These laws may differ in the scope of liability they impose and in other aspects. Nonetheless, they represent a growing acceptance among regulators of the need to regulate this conduct."); Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 195 (2001) ("Insider trading regulation is among the prominent subjects, which underwent a strong convergence process as part of the internationalization of securities markets. As a result, one is likely to find laws, which prohibit insider trading in many countries in quite similar language."); Robert A. Prentice, *The Internet and its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J. LAW & TECH. 263, 349–50 (1999) ("[I]n no field has the SEC been more successful at producing . . . convergence than in insider trading. It is now possible to speak of an 'emerging global consensus favoring punishment [of insider trading] activity because it undermines the integrity of the marketplace and threatens the market's efficiency.'").

84. *See* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999) (describing the metaphoric "path dependency" of U.S. insider trading law); Gevurtz, *supra* note 32, at 68 ("[I]nsider trading prohibitions around the world differ as to when it is illegal for a party in possession of information unknown to the other side to buy or sell stock without first disclosing the information."); Steinberg, *supra* note 21, at 635 (noting, with respect to both insider trading and issuer affirmative disclosure requirements, that "a survey of the securities laws of developed markets reveals that these countries have rejected the U.S. approach.").

85. *See generally* Gevurtz, *supra* note 32, at 68–89 (comparing insider trading prohibitions in the United States, under the EU Directive, in Australia, and in Japan); Steinberg, *supra* note 21, at 662–72 (describing various similarities and differences in insider trading laws in developed countries). When I began researching the laws of Japan and Germany in 2004, there were no English translations of the relevant statutes available on the Web. I am deeply indebted to Hilary Foulkes and Bob Wray, two of my former colleagues at Skadden, Arps, Slate, Meagher & Flom LLP, and Stefan Koch, also of Skadden, Arps, Slate, Meagher & Flom LLP, for their assistance in getting me English translations of each statute. I also will take this opportunity to thank Lauren Medley Gunnels (J.D., 2006, The University of Tennessee College of Law), who provided assistance in the early stages of my research.

86. *See* Shelby D. Green, *To Disclose or Not to Disclose? That Is the Question for the Corporate Fiduciary Who Is Also a Pension Plan Fiduciary Under ERISA: Resolving the Conflict of Duty*, 9 U. PA. J. LAB. & EMP. L. 831, 841 (2007) (setting forth these three justifications); Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 BROOKLYN L. REV. 149 (1993) (book review) (describing all three justifications and critiquing the property law basis for insider trading regulation); *see also* Ray J. Grzebielski, *Why Martha Stewart Did Not Violate Rule 10b-5: On Tipping, Piggybacking, Front-Running and the Fiduciary Duties of Securities Brokers*, 40 AKRON L. REV. 55, 72 (2007) ("A significant policy reason to prohibit insider trading is to protect the corporation's property rights in the information."); Loke, *supra* note 22, at 170–71 (describing the fiduciary duty and parity of information justifications); Nnona, *supra* note 80, at 207–10 (noting four broad justifications for insider trading regulation); Bryan C. Smith, Comment: *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371, 381 (1999) ("[T]hree considerations routinely pointed to as reasons to prohibit insider trading are: (1) Equity or Fairness, (2) Property Rights, and (3) Efficiency.").

87. Bainbridge, *supra* note 84, at 1598 ("The equality of access principle admittedly has some intuitive ap-

peal. . . . [T]he SEC consistently has tried to maintain it as the basis of insider trading liability."); Coles, *supra* note 44, at 184 ("Through its enforcement policies and legal positions advocated in judicial proceedings, the SEC is constantly pushing the boundaries of the law in an attempt to bring insider trading restrictions quietly and indirectly back to a fairness-based system—a system that has ostensibly been rejected by the Supreme Court.").

88. *See*, *e.g.*, Bainbridge, *supra* note 84, at 1644–50 (arguing that insider trading should be based on property right protections rather than securities fraud); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179 (1991) (providing a critique and suggesting an alternative).

89. A. C. Pritchard, United States v. O'Hagan*: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U.L. REV. 13, 17 (1998).

90. *Id.* ("The relationship between a principal and an agent is a fiduciary relationship."); *see also* Restatement (Third) of Agency § 1.01 (including especially cmt. e).

91. Restatement (Third) of Agency § 8.01 (2006). As noted in the comments to this rule, "Unless the principal consents, the general fiduciary principle, as elaborated by the more specific duties of loyalty stated in §§ 8.02 to 8.05, also requires that an agent refrain from using the agent's position or the principal's property to benefit the agent or a third party." *Id.* at cmt b.

92. *Id.* at § 8.02.

93. *Id.* at § 8.05.

94. *Id.* at cmt. c.

95. *See, e.g., id.* at § 8.01 cmt. d(1) ("The law of restitution and unjust enrichment . . . creates a basis for an agent's liability to a principal when the agent breaches a fiduciary duty. . . . If through the breach the agent has realized a material benefit, the agent has a duty to account to the principal for the benefit, its value, or its proceeds. The agent is subject to liability to deliver the benefit, its proceeds, or its value to the principal."); *see also Diamond v. Oreamuno*, 248 N.E.2d 910, 914 (N.Y. 1969).

96. Restatement (Third) of Agency § 8.02 cmt e.

97. *See supra* note 45–47 and accompanying text.

98. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (citation omitted).

99. *See supra* notes 41–44 and accompanying text.

100. *See* Nagy, *supra* note 28, at 1323–24 ("The classical and misappropriation theories of insider trading liability establish the circumstances under which such a disclosure duty arises and . . . under either of the Supreme Court's theories, the existence of a fiduciary-like relationship is essential.").

101. *See* Pritchard, *supra* note 89.

102. Nagy, *supra* note 28, at 1319 ("Despite the fact that fiduciary principles underlie the offense of insider trading, there have been recent repeated instances in which lower federal courts and the Securities and Exchange Commission . . . have disregarded these principles.").

103. Steinberg, *supra* note 21, at 666.

104. *Id.* at 667 (footnotes omitted).

105. *Id.* at 666–67 ("[A]s a matter of fairness, the U.S. framework has significant loopholes. . . . By adhering to a fiduciary relationship like-model . . . , the U.S. insider trading approach unduly complicates an already complex area and at times smacks of unfairness among similarly situated market participants." (footnotes omitted)).

106. A student commentator noted that "the misappropriation theory makes potential liability less predictable under section 10(b), and the *O'Hagan* decision does nothing to alleviate the problem. When addressed with this problem in the past, the Supreme Court has emphasized that the securities market "demands certainty and predictability," and that it is "essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's insider-trading rules." . . . "[I]n several cases where courts have imposed liability under the misappropriation theory, the breach has not been . . . clear." Amy E. Fahey, Note: United States V. O'Hagan: *The Supreme Court Abandons Textualism to Adopt the Misappropriation Theory*, 25 FORDHAM URB. L. J. 507, 538–39 (1998).

107. 17 C.F.R. § 240.10b5–2(b) (2010).

108. *Id.*

109. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

110. *Id.* at 724–27.

111. *See* Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading after* United States v. O'Hagan, 84 VA. L. REV. 153, 208 (1998) ("[W]e can anticipate that the types of relationships ultimately subject to the *O'Hagan* insider trading regime will continue to expand. Relationships of confidence often arise without being designated as such by the persons entering into them, and in most circumstances persons in a fiduciary relationship cannot simply choose to characterize their relationship as nonfiduciary.").

112. *See* Joan MacLeod Heminway, *Save Martha Stewart? Observations about Equal Justice in U.S. Insider Trading Regulation*, 12 TEX. J. WOMEN & L. 247, 285 n.31 (2003) (noting that allegations in the SEC's complaint against Martha Stewart "appear to suggest that the SEC desires to extend tippee liability to tippees of third-party brokers who misappropriate personal trading information from insiders"); David A. Skeel Jr. & William J. Stuntz, *Christianity and the (Modest) Rule of Law*, 8 U. PA. J. CONST. L. 809, 827 (2006) (describing the expansiveness of the SEC's breach of duty theory in its insider trading case against Martha Stewart); Lawrence M. Solan, *Statutory Inflation and Institutional*

Choice, 44 WM. & MARY L. REV. 2209, 2243 (2003) ("[B]y the time *O'Hagan* was decided, both the Justice Department and the SEC for many years had been attempting to expand liability for insider trading. They had failed twice before the Supreme Court, and had won an affirmance by an equally divided Court. *O'Hagan*, the government's fourth effort, was a success."); Dave Michaels & Brendan Case, *Legal Stars Defend Cuban: Team of Professors from Top Law Schools Attacks SEC Authority*, DALLAS MORNING NEWS, Feb. 3, 2009, at D1 (describing a challenge to the SEC's insider trading case against Mark Cuban on the basis of a lack of duty).

113. *See supra* notes 98 & 99 and accompanying text; *see also* Gevurtz, *supra* note 32, at 80–81.

114. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) ("The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.").

115. *See* H.R. 682, 111th Cong., 1st Sess. (2009); *Brian Introduces Legislation to Prohibit Insider Trading on Capitol Hill*, Jan. 27, 2009, *available at* http://insidertrading.procon.org/sourcefiles/BairdPressRelease09.pdf.

116. Masanori Hayashi, Note: *Japanese Insider Trading Law at the Advent of the Digital Age: New Challenges Raised by Internet and Communication Technology*, 23 HASTINGS COMM. & ENT. L. J. 157, 161–62 (2000).

117. Financial Instruments and Exchange Act, art. 166(1), Apr. 1, 2008, *available at* www.fsa.go.jp/common/law/fie01.pdf; *see also* Gevurtz, *supra* note 32, at 83 ("The Japanese prohibition reaches so-called corporate related parties. This includes directors, officers, employees, shareholders, as well as persons associated with a corporation through either a contract or a government supervisory role, who obtain material non-public information by virtue of their relationship with the company.").

118. Gevurtz, *supra* note 32, at 83.

119. *Id.* at 84.

120. Financial Instruments and Exchange Act, art. 166(3), Apr. 1, 2008, *available at* www.fsa.go.jp/common/law/fie01.pdf; *see also* Gevurtz, *supra* note 32, at 83–84 ("Under Japanese law, persons receiving non-public information directly from corporate related parties are subject to the prohibition on trading. . . . [U]nlike the United States' law . . . , the Japanese prohibition only extends to a person who receives information directly from a corporate related party, and not to remote tippees."); *id.* at 86 ("[T]he . . . way in which the Japanese law deals with the problem is by punishing first-tier recipients of information who trade.").

121. *See* Gevurtz, *supra* note 32, at 84 (noting "Japan's failure to adopt the equivalent of . . . the United States' misappropriation theory" and, by way of explanation, "that at the time the Japanese enacted their insider trading provisions in 1988, the United States Supreme Court had not accepted the misappropriation theory—at least in the context of a securities law violation."); *id.* at 86 ("Japan has the narrowest law. The Japanese statute does not prohibit tipping.").

122. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz-WpHG*), Part 3, Sections 13 & 14, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start; *see also* Memminger, *supra* note 67, at 205 ("The broad formulation of Section 13 of the German Securities Trading Act, however, qualifies every person or legal entity that has knowledge of inside information as an insider.").

123. *Id.*; *see also* Karmel, *supra* note 68, at 1150–51 (describing primary and secondary insiders under the prior German statutory scheme); Memminger, *supra* note 67, at 205–12 (same); Calaba, *supra* note 67, at 470 (same).

124. *Cf. id.* at 211–12 (making this point under Germany's prior statute).

125. Council Directive 2003/6/EC, 2003 O.J. (L 96) 16; *see also* Council Directive 2003/124/EC, 2003 O.J. (L 339) 70. I am extremely grateful for the assistance in this area that I received from Prof. Dr. Gerhard Wegen, LL.M. and Dr. Felix Born of Gleiss Lutz in Hootz Hirsch Partnerschaftsgesellschaft von Rechtsanwälten, Steuerberatern (AG Stuttgart PR 136) in Stuttgart, Germany, for their assistance with these and related materials.

126. Pfeil, *supra* note 67, at 176–77.

127. *See supra* notes 115, 117, 120, and 126 and accompanying text.

128. *See supra* notes 113, 120, 121 & 124 and accompanying text.

129. *See supra* notes 106–12 and accompanying text.

130. *See, e.g.*, *SEC v. Mayhew*, 121 F.3d 44, 50–51 (2d Cir. 1997) (discussing the meaning of nonpublic information); *SEC v. Conaway*, 2010 U.S. Dist. LEXIS 4254, at *145-*163 (E.D. Mich. Jan. 20, 2010) (discussing implied misrepresentations as facts). Under German insider trading law, facts include forward-looking information. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz-WpHG*), Part 3, Section 13, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start (noting that circumstances forming the basis of inside information include "cases which may reasonably be expected to come into existence in the future").

131. Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763, 824 (1995).

132. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (*citing to TSC Indus., Inc. v. Northway, Inc.*, 426

U.S. 438, 449 (1976)); *see also* Heminway, *supra* note 23, at 1137–38.

133. *Basic*, 485 U.S. at 232 (noting the potential materiality of contingent or speculative information); SEC SAB No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) (referenced at 17 C.F.R. pt. 211) (providing materiality guidance in the context of accounting disclosures); Heminway, *supra* note 132, at 1200–01, 1160 n.114 (describing the task of balancing quantitative and qualitative materiality and the materiality of contingent, speculative, and forward-looking information).

134. *United States v. Anderson*, 533 F.3d 623, 629 (8th Cir. 2008) (citations omitted).

135. *Basic*, 485 U.S. at 232–41.

136. *United States v. Nacchio*, 519 F.3d 1140, 1158 (10th Cir. 2008).

137. *Endo v. Albertine*, 863 F. Supp. 708, 717 (N.D. Ill. 1994) ("'The Issue [sic] of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts.' . . . Only if the established misrepresentations or omissions are so obviously important or so obviously unimportant to an investor, that reasonable minds cannot differ on the question of materiality, can the ultimate issue of materiality be appropriately resolved as a matter of law at the summary judgment stage." (citation omitted)).

138. Financial Instruments and Exchange Act, art. 166(2), Apr. 1, 2008, *available at* www.fsa.go.jp/common/law/fie01.pdf.

139. *Id.*

140. *See, e.g.*, *id.* art. 166(2)(i)(o), 166(2)(ii)(d), and 166(2)(iii)(h).

141. Gevurtz, *supra* note 32, at 73–74 (footnotes omitted).

142. *See generally* Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior*, 42 WAKE FOREST L. REV. 749 (2007); Allan Horwich, *When the Corporate Luminary Becomes Seriously Ill: When Is a Corporation Obligated to Disclose That Illness and Should the Securities and Exchange Commission Adopt a Rule Requiring Disclosure?* 5 N.Y.U. J. L. & BUS. 827 (2009); Jeff Poor, *Gore, Other Apple Directors Face Possible Suit over CEO Jobs' Health*, BUS. & MEDIA INSTIT., Jan. 17, 2009, *available at* www.businessandmedia.org/articles/2009/20090117125945.aspx; Dunstan Prial, *Can We Trust What CEOs Say?* FOXBUSINESS, March 9, 2009, *available at* www.foxbusiness.com/story/markets/trust-ceos-say/.

143. Steinberg, *supra* note 21, at 664 (footnotes omitted) ("The U.S. standard, focusing on whether the subject information would assume importance to the mythical 'reasonable' investor in making his investment decision, has not been adopted with great frequency elsewhere.").

144. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 13, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start.

145. *Id.*

146. *Id.*

147. *See* Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 13, Sept. 9, 1998, *available at* www.iuscomp.org/gla/statutes/WpHG.htm#13; *see also* Karmel, *supra* note 68, at 1151 (describing the price-effect standard under a prior version of the German statute); Steinberg, *supra* note 21, at 664–65 (same); Calaba, *supra* note 67, at 472 (same).

148. Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 13, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start.

149. *Id.*; *see also* Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz- WpHG*), Part 3, Section 15(1), Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* www.BaFin.de/cln_171/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg_28neu_29__en.html#Start ("[I]nside information directly concerns an issuer if it relates to developments within the issuer's sphere of activity."); *see also* Memminger, *supra* note 67, at 201 (mentioning and explaining, under a prior version of the German statute, this aspect of the definition of inside information).

150. *See supra* note 142 and accompanying text.

151. *See supra* notes 132–37 and accompanying text.

152. *See, e.g.*, Heminway, *supra* note 142, at 759 ("Although personal facts about an executive are less likely to be material than corporate facts, a court may find that it is substantially likely that a reasonable investor would consider certain personal facts important in making an investment decision relating to the corporation's securities. Moreover, a court may find it substantially likely that a reasonable investor would have viewed disclosure of an omitted personal fact about an executive officer as a significant alteration of the total mix of available information." (footnotes omitted)).

153. *See supra* notes 138–42 and accompanying text.

154. *See supra* notes 144–50 and accompanying text.

155. *Cf.* Heminway, *supra* note 23, at 1174–82 (describing transaction costs associated with materiality determinations in an insider trading context).

156. *See id.* at 1138–39 ("The interpretation and application of the materiality standard are highly fact-dependent and do not always produce predictable or certain planning options or judicial results.").

157. *See* 17 C.F.R. § 240.10b5–1 (2010) ("a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale"); Langevoort, *supra* note 25, at 13 (noting that an awareness standard is applicable after the adoption of Rule 10b5–1); Elena Marty-Nelson, *Securities Laws in Soap Operas and Telenovelas: Are All My Children Engaged in Securities Fraud?* 18 S. CAL. INTERDIS. L. J. 329, 351 (2009) ("The Third Circuit has found that recklessness amounts to scienter.").

158. *See* Marty-Nelson, *supra* note 157, at 351 ("Generally, when dealing with tippee liability, the requisite mental state may be found when the tippee 'knew,' or 'should have known,' or perhaps even 'consciously avoided' knowing that she was trading on improperly divulged nonpublic information." (footnote omitted)).

159. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) ("The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10 (b) was intended to proscribe knowing or intentional misconduct.").

160. 17 C.F.R. § 240.10b5–1 (2010).

161. *See* Carol B. Swanson, *Insider Trading Madness: Rule 10b5–1 and the Death of Scienter*, 52 KAN. L. REV. 147, 193–96 (2003).

162. *Id.* at 196–200.

163. *See supra* notes 53–58 and accompanying text (regarding the Japanese law); *supra* notes 75 & 76 and accompanying text (regarding the German law).

164. *See*, *e.g.*, Greenberg, *supra* note 4, at 307. In *Chiarella*, the Court stated that "not every instance of financial unfairness constitutes fraudulent activity under § 10 (b)." *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

165. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U.L. REV. 443, 474–75 (2001) (footnotes omitted).

166. Dunoff, *supra* note 3, at 908 (describing one author's conception of "level playing field" fairness and noting its connection to equal access principles); Thomas A. McGrath III, Note: *The Rise and Fall (and Rise?) of Information-Based Insider Trading Enforcement*, 61 FORDHAM L. REV. 127, 129 (1993) ("The original theory of insider trading—the equal access theory—was premised on considerations of fairness and the public interest in market participants having equal access to corporate information—'the level playing field.'").

167. *Id.* at 476–77 (footnotes omitted); *see also* Cox & Fogarty, *supra* note 3, at 360 ("Fairness as equal access to information may be seen, then, . . . as an attempt to prevent exploitation of unearned informational advantages, to promote equality of opportunity in the securities markets, or, more starkly, to transfer wealth from the informed to the uninformed. In this respect, insider trading is unfair much in the sense that inheritances, or even good luck, are unfair; and an insider trading prohibition is not so much an antifraud rule as a law against easy money.").

168. To this point, Professor Krawiec noted, "An investor's sense of the unfairness of securities markets is . . . unlikely to be assuaged by reassurances that the material information possessed by her trading partner and not by her is technically public and that if she cares to quit her job and instead spend all day monitoring courtroom trials, searching for obscure public reports or loitering at corporate offices she is likely to discover this same information. Rather, investors are likely to feel that such transactions are unfair regardless of whether the unshared information was acquired through breach of a fiduciary duty, through theft, from a disclosure made to analysts in a closed session, or from information that, while public in theory, is simply beyond the reach of the average investor." Krawiec, *supra* note 165, at 479.

169. Cox & Fogarty, *supra* note 3, at 359.

170. *See supra* notes 15 & 16 and accompanying text.

171. Rawls, *supra* note 7, at 48.

172. Rawls, *supra* note 7, at 43.

173. One commentator on U.S. insider trading regulation wrote, "The current fraud-based law of insider trading does not promote the policies of fairness and equal access to information underlying the federal securities laws. The fiduciary principle narrows the scope of insider trading liability to such an extent that many traders, unfairly using their privileged access to information, are beyond the reach of the statute. As a result, present law is inadequate to curtail widely condemned activity." Jeffrey P. Strickler, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*, 73 CALIF. L. REV. 483, 496 (1985).

174. *See supra* note 17 and accompanying text.

175. Small, *supra* note 60, at 1455 ("Law is a product of its context as well as its culture.").

176. JOHN RAWLS, THE LAW OF PEOPLES 37 (1999).