3-23-2009

Common Roots, Divergent Evolution: Insider Trading Doctrine in the United States, Japan, and Germany

Joan MacLeod Heminway
University of Tennessee College of Law

3-23-2009

Common Roots, Divergent Evolution: Insider Trading Doctrine in the United States, Japan, and Germany

Joan M. Heminway

Preliminary Draft – For Discussion Purposes Only
March 23, 2009

COMMON ROOTS, DIVERGENT EVOLUTION: INSIDER TRADING DOCTRINE IN THE UNITED STATES, JAPAN, AND GERMANY

Joan MacLeod Heminway[1]

Many nations ostensibly use (or at least credit) U.S. insider trading doctrine under Rule 10b-5[2] as the model for their own regulation of insider trading.[3] 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, the central focus of insider trading regulation under Rule 10b-5.[4]

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 in other countries.[5] For example, U.S. insider trading doctrine fosters, supports, and protects, first and foremost, a fiduciary duty (that of an agent to a principal) rather than affording primacy to informational fairness

[1] Associate Professor, The University of Tennessee College of Law; A.B. 1982, Brown University; J.D. 1985, New York University School of Law. Many thanks are owed to my former colleagues at Skadden, Arps, Slate, Meagher & Flom LLP, Hilary Foulkes and Bob Wray who, back in the spring of 2004, supplied me with excellent English translations of the Japanese and German insider trading laws described in this paper as a means for getting me started in my primary statutory research. Earlier versions of this paper (or part of it) were presented at The University of Tennessee Corporate Governance Center, the Southeastern Association of Law Schools, and the Law and Society Association. Work on this paper was supported by summer grant funding from The University of Tennessee College of Law.
[2] 17 C.F.R. § 240.10b-5 (2008). 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).
[3] *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.").
[4] *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.").
[5] *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.").

(whether in the form of equal access to information or strict informational parity).[6] 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 duty referenced in the preceding sentence) rather than a specified person or entity affiliated or associated with the issuing corporation in a defined way.[7] Moreover, U.S. insider trading rules broadly protect investors against market and nonmarket risks (through an expansive definition of materiality), while regulation in other countries protects investors against market risks only (by focusing on market-affecting information).[8]

This paper describes the common roots and divergent developmental paths of insider trading rules in the United States, Japan, and Germany and endeavors to place them in a meaningful international legal, political, economic, and social context. Specifically, Part I of the paper identifies the common bases of insider trading doctrine in the three exemplar countries. Part II then describes the divergent evolutions of insider trading rules in these countries in certain key respects and articulates ways in which the observed differences in current insider trading doctrine may be significant. Finally, Part III isolates possible reasons for the existence and persistence of the observed doctrinal divergence as among the United States, Japan, and Germany. The paper ends with a brief conclusion. Distinct political, economic, and societal histories, and differences in legal systems and traditions, are at issue in all aspects of the comparative observations and analyses.

I. COMMON ROOTS: BASIC PRINCIPLES; INTERTWINED HISTORIES

The insider trading laws of the United States, Japan, and Germany 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 Japan and Germany as part of an international effort to encourage insider trading regulation consistent with the

---

[6] 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").

[7] 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 rests 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).

[8] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); *see* Heminway, *supra* note 7, at 1158-60 (describing the status of a "market effect" test under U.S. insider trading law).

Electronic copy available at: http://ssrn.com/abstract=2436589

predominant U.S. model. This Part summarizes the adoption of insider trading regulation in each of the three exemplar countries.

A. U.S. Insider Trading Regulation

In the United States, insider trading is principally regulated by Rule 10b-5, although the rule is not narrowly tailored to address insider trading. Rather, it is a general fraud prohibition that has been shaped, principally by judge-made law, to include insider trading. 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.[9]

Typically, insider trading is deemed to violate subparagraph (a) or subparagraph (c) of Rule 10b-5, since insider traders remain silent; they withhold, rather than make, statements.[10]

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 (the "1934 Act").[11] 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

---

[9] 17 C.F.R. § 240.10b-5 (2009).

[10] *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*, Jan. 2009, at 8, *available at* http://ssrn.com/abstract=1335494 (explaining how silence can constitute fraud by deception under Rule 10b-5).

[11] 15 U.S.C. § 78j(b) (2007).

> 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.[12]

Specific restrictions developed in decisional law construing Section 10(b) and Rule 10b-5 prohibit (under certain circumstances) insider trading transactions and tipping. 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 (while 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 when I denied Transamerica's motion for summary judgment.[13]

---

[12] *Id.*

[13] Speed v. Transamerica Corp., 99 F. Supp. 808, 828-829 (D. Del. 1951) (footnote and citation omitted). In an earlier case, the United Sstates District Court for the District of Pennsylvania found that,

> [u]nder 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).

Only with a 1961 SEC enforcement action, however, did modern U.S. insider trading law link itself to Rule 10b-5.[14] 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.[15] 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.[16]

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;[17] a fact is public if it has been "effectively disclosed in a manner sufficient to insure its availibility [sic] to the investing public."[18] *Cady, Roberts* was followed by a number of other cases in federal court, notably including *SEC v. Texas Gulf Sulphur*,[19] 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.[20]

In the post-*Cady, Roberts* era, the basic tenets of U.S. insider trading doctrine have been shaped principally by three U.S. Supreme Court cases decided over the past 30 years. The Supreme Court's 1980 decision in *United States v. Chiarella*[21] endorses and reinforces the "disclose or abstain" rule articulated in *Cady, Roberts*. Under *Chiarella*, public issuers of securities and their insiders cannot trade in the issuer's securities while

---

[14] Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 71 (2002) (noting that after the 1942 adoption of Rule 10b-5, "[n]early two decades passed before anyone applied Rule 10b-5 to trading on undisclosed inside information.").
[15] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).
[16] *Id.*
[17] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (endorsing these alternative standards for materiality).
[18] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 854 (2d Cir. 1968), *cert, denied,* 394 U.S. 976 (1969).
[19] *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.").
[20] *Id.*; *In re* Cady, Roberts & Co., 40 S.E.C. at 912. *See also supra* note 13.
[21] Chiarella v. United States, 445 U.S. 222 (1980).

in possession of material, nonpublic information.[22]

Three years later, in 1983, the Supreme Court decided *Dirks v. SEC*.[23] *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.[24] Effectively, under *Dirks*, (1) a tipping insider is liable if he breaches his fiduciary duty to the corporation and its shareholders by improperly disclosing material nonpublic information and (2) a tippee is liable if the tipping insider breaches his fiduciary duty by disclosing material nonpublic information to the tippee and the tippee knows or should know of the breach.[25] A tippee does not have to receive information directly from the insider in order to be held liable for the trade, and the tipper may be liable for trading by an indirect tippee.[26]

Finally, in 1997, the Supreme Court decided the third case in the trilogy, *United States v. O'Hagan*.[27] 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 which the trader owes a duty of trust and confidence.[28] The insider trading liability in this context is based on the trader's "deception of those who entrusted him with access to confidential information."[29]

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 regulation); insider tipping of material nonpublic information to those who may trade on that information (known as "tipper liability"); trading by those tipped off on material nonpublic information who have knowledge that they are not entitled to have or trade on that information (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

[22] *Id.* at 228.
[23] Dirks v. SEC, 463 U.S. 646 (1983).
[24] *Id.* at 660.
[25] *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)).
[26] 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 25, 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.").
[27] United States v. O'Hagan, 521 U.S. 642 (1997).
[28] *Id.* at 652-53.
[29] *Id.* at 652.

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 (15 U.S.C. 78j) 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.[30]

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.[31]

B. 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.[32] Although the Japanese Securities and Exchange Law of 1948 (or "SEL," now known as the Financial Instruments and Exchange Act or "FIEA") included a provision like U.S. Section 10(b), it was not used to enforce insider trading prohibitions.[33]

> 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

[30] 17 CFR 240.10b5-1 (2009).

[31] 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.

[32] 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.").

[33] *See* Lu, *supra* note 32, 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 catch-all 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 32, 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.").

> 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.[34]

A more direct form of insider trading regulation was implemented in 1988 in response to pressure from the United States and other developed nations.[35] Then-current facts indicating a significant instance of insider trading also acted as a catalyst for the 1988 changes.[36] "The 1988 amendments are premised on the concept that insider trading is unfair and violations rightfully should be punished."[37] 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.[38] 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,[39] the statute does not provide for indirect tippee liability, tipper liability, or liability premised on misappropriation.[40]

---

[34] Lu, *supra* note 32, at 186-188.

[35] 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 32, at 193-94 (describing the impetus for insider trading initiatives in a number of countries in the late 1980s); Osaki, *supra* note 32, 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 id.* at 185 (noting and describing the 1988 amendments).

[36] *See* Lu, *supra* note 32, at 195-97; Osaki, *supra* note 32, at 145.

[37] 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).

[38] Financial Instruments and Exchange Act, Art. 166(1), Apr. 1, 2008, *available at* http://www.fsa.go.jp/en/refer/legislation/index.html.

[39] Financial Instruments and Exchange Act, Art. 166(3), Apr. 1, 2008, *available at* http://www.fsa.go.jp/en/refer/legislation/index.html. *See also* Gevurtz, *supra* note 14, 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 25, at 165 ("Under Japanese law, the tipping rule

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.[41] In the 1990s, enforcement activity increased, although not by any measure to the level of enforcement activity in the United States.[42] 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.[43] "[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.'"[44] Japanese insider trading enforcement has continued to increase, however, in the new millennium, with the introduction of civil fines in 2005 amendments to the SEL.[45] Assessments of these fines are made by administrative order after an administrative investigation.[46] These orders, unchallenged by the alleged violators, represent significant progress in enforcing insider trading prohibitions in Japan.[47] Recent 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.[48]

C. 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

---

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.").

[40] *See* Coles, *supra* note 26, 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 14, 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 25, 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.").

[41] Lu, *supra* note 32, 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 "[i]n 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.").

[42] Nasser, *supra* note 35, at 382 (summarizing Japanese enforcement of insider trading in the 1990s); Osaki, *supra* note 32, 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.").

[43] 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.").

[44] Kehoe, *supra* note 37, at 375.

[45] *See* Osaki, *supra* note 32, at 152-54 (describing a recent case and the adoption and operation of the civil fine system).

[46] *Id.* at 153.

[47] *Id.* at 153-54.

[48] *See Japan to double fines for insider trading*, JAPAN WEEKLY MONITOR, June 9, 2008.

engaging in certain trading transactions.[49] These informal pronouncements were wholly unsuccessful as a means of combating German insider trading.[50]

In 1994, Germany criminalized insider trading.[51] Germany was the last European Community ("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.[52] A second EC Directive was adopted in 2003, resulting in adjustments to the original regulatory framework.[53]

The United States, acting through the SEC, was an impetus behind both the EC Directive and (ultimately) Germany's law.[54] 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

---

[49] 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).

[50] Blum, *supra* note 49, 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 49, 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.").

[51] 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 43, 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 49, at 4-5, 40 (noting the adoption and effectiveness of criminal insider trading legislation in Germany); Karmel, *supra* note 50, 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 49, 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 49, at 137, 152 (noting the adoption and effectiveness of German criminal insider trading sanctions).

[52] Calaba, *supra* note 49, at 470; Karmel, *supra* note 50, at 1150; Pfeil, *supra* note 49, at 149.

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

[54] Colombatto & Macey, *supra* note 43, at 952; Karmel, *supra* note 50, 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).

efforts, and adapt to technological developments."[55] Like Japan, Germany was dealing with capital market dislocations (attributable to various causes, including a then current insider trading scandal) at the time it adopted legislative insider trading prohibitions.[56]

Under Germany's insider trading law,[57] "[i]nsiders 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."[58]

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*").[59] The law contemplates "a three-tiered surveillance structure on the federal, state (*Lander*), and exchange levels."[60]

---

[55] Pfeil, *supra* note 49, at 144.

[56] 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 49, at 54 (footnotes omitted).

[57] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Section 14, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* http://www.bafin.de/cln_116/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText19.

[58] *Id. See also* Freis, *supra* note 49, at 41. *See also* Karmel, *supra* note 50, at 1150-51 (explaining prohibited conduct); Memminger, *supra* note 49, at 215-226 (same).

[59] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Section 14, Sept. 9, 1998 (last amended Jan. 1, 2007), *available at* http://www.bafin.de/cln_116/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText6. *See also* Freis, *supra* note 49, 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 50, 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 49, 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

D. Summary

The United States was an early adopter of insider trading regulation and became the international leader in the diaspora of that regulation among nations with developed public securities markets.[61] 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, among them, 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.[62]

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

---

responsible for investigations of insider trading, protection of investors, improvements to market transparency, and cooperation on the international level." (footnotes omitted)).

[60] Pfiel, *supra* note 49, 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* http://www.bafin.de/cln_116/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText10; Freis, *supra* note 49, 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 49, at 173 (describing the operation of the components of the regulatory structure).

[61] ~~Robert A.~~ Prentice, ~~*The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775~~*supra* note 4, at 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.").

[62] 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. 148 Similarly, the SEC 'made its disapproval of [Germany's] current system known both directly and indirectly through the prosecution of high-profile casesthat violate United States insider trading laws.'").

trading laws has been inconsistent over time,[63] Japanese and German insider trading laws provide for enforcement through regulatory bodies modeled after the SEC.[64] The initial policy basis for the insider trading doctrine in all three countries is informational fairness.

A number of commentators note these and other similarities in the regulatory frameworks of the three countries and assume regulatory convergence.[65] This assumption 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,[66] and this paper extends that literature.

II. DIVERGENT DEVELOPMENT: AGENCY LAW, DUTY, FAIRNESS, INSIDER STATUS, MATERIALITY, AND INFORMATION MARKETS

Despite the common roots and 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.[67] This Part describes and explains the significance of three of these divergent aspects of insider trading law development: the increasingly central role that agency law—and particularly fiduciary 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" is; and differences in defining the type of information that may trigger the application of the "disclose or abstain" rule. Each of these aspects of insider trading law is important in that the differences contribute

---

[63] Colombatto & Macey, *supra* note 43, 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).").

[64] Prentice, *supra* note 51~~51~~4, at 834.

[65] *See also* Licht, *supra* note 3, 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 & Tec 263, 349-350 (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.'").

[66] *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 14, 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 5, 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.").

[67] *See generally* Gevurtz, *supra* note 14, at 68-89 (comparing insider trading prohibitions in the United States, under the EU Directive, in Australia, and in Japan); Steinberg, *supra* note 5, at 662-72 (describing various similarities and differences in insider trading laws in developed countries).

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.

A. A Required Breach of Fiduciary Duty Based in Agency Law: A Unique Primary Policy Focus for Insider Trading Doctrine in the United States

"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."[68]

The regulation of insider trading can be justified along a number of different—but not wholly distinct—policy continuums, including the safeguarding of fiduciary duties relating to an agent's proper use of her principal's information, the promotion of fairness in the market for information (whether through equal access to or a strict parity of information), and the protection of property rights in information.[69] In the United States, despite the SEC's continued promotion of an informational fairness rationale[70] and pointed scholarly critiques urging policy justifications other than the promotion of fiduciary duties,[71] U.S. insider trading doctrine has developed as a specific type of securities fraud, primarily rooted in fiduciary duty principles that originate in agency law.

This doctrinal foundation is not without some merit, and it overlaps with notions of informational fairness and property rights. Under general principles of agency law,

---

[68] 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).

[69] *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 66, at 170-71 (describing the fiduciary duty and parity of information justifications); Nnona, *supra* note 62, 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.").

[70] Bainbridge, *supra* note 66, at 1598 ("The equality of access principle admittedly has some intuitive appeal. . . . [T]he SEC consistently has tried to maintain it as the basis of insider trading liability."); Coles, *supra* note 26, at 184 (2005/2006) ("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.").

[71] *See, e.g.*, Bainbridge, *supra* note 66, 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).

agents are fiduciaries.[72] "An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."[73] Accordingly, "[a]n 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."[74] As part of this duty, "[a]n 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."[75] 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.[76]

The agent is liable to the principal for a breach of these prescribed duties.[77] Possible remedies may 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.[78]

In its opinion in the *O'Hagan* case (affirming the misappropriation theory),[79] the Supreme Court summarized the linkage between these agency law fiduciary duties and the U.S. law of 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

---

[72] *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).
[73] RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006). As noted in the comments to this rule, "[u]nless 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.* cmt b.
[74] *Id.* § 8.02.
[75] *Id.* § 8.05.
[76] *Id.* cmt. c.
[77] *See, e.g., id.* § 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).
[78] RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt e.
[79] *See supra* note 27-29 and accompanying text.

> 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. [80]

Since, under U.S. insider trading law, a tippee effectively assumes the fiduciary duty of the tipper if the tippee knows that the tipper had and breached a duty of trust and confidence in making the tip, tipper and tippee liability also is premised on the breach of a fiduciary duty arising out of agency law.[81] 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 duty.[82] As such, U.S. insider trading regulation under Rule10b-5 is inextricably intertwined with agency law principles.[83]

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 still play a role (and arguably, based on recent lower court decisions and SEC activity, an increasing role) in the regulation of insider trading in the United States.[84]

Moreover, fiduciary duty principles do not well explain the law governing insider trading in other countries.[85] Neither Japanese nor German law ties insider trading liability to the existence and breach of a duty by a fiduciary. Rather, these two nations 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."[86]

---

[80] United States v. O'Hagan, 521 U.S. 642, 652 (1997) (citation omitted).
[81] *See supra* notes 23-26 and accompanying text.
[82] *See* Nagy, *supra* note 10, at 8 ("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.").
[83] *See* Pritchard, *supra* note 68.
[84] Nagy, *supra* note 10, at 3 ("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 ('SEC') have disregarded these principles.").
[85] [cites]
[86] Steinberg, *supra* note 5, at 666.

Instead, the insider trading doctrine in Japan, Germany, and elsewhere primarily serves informational fairness objectives. Specifically,

> [M]any 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.[87]

Although the United States does regard fairness as a significant policy consideration underlying insider trading regulation, the primary fiduciary duty emphasis of U.S. doctrine may compromise certain fairness considerations.[88]

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 duty may be under-inclusive or over-inclusive 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 duty does not violate U.S. insider trading law under Rule 10b-5, but is likely or sure to violate insider trading prohibitions under Japanese or German law. On the other hand, a person possessing material nonpublic information who has and breaches a fiduciary duty by trading in securities or tipping the material nonpublic information violates U.S. insider trading law but may not violate the insider trading law of Japan, for example, if the person's position does not make him an insider (i.e., 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 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.[89] Over time, insider trading law in the United

---

[87] *Id.* At 667 (footnotes omitted).

[88] *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)).

[89] A student commentator notes that

> [T]he 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, 538-539 (1998).

States has developed through SEC rulemaking and decisional law to incorporate and protect various different fiduciary relationships in which a person with knowledge of material nonpublic information trades securities or tips others who trade or pass on the tip. There is no defined list of relationships that give rise to the liability-creating fiduciary duty; apart from precedent and nonbinding guidance provided in federal court opinions, the law of agency, which is theory may evolve from case to case, provides the outer limits of a definition.[90] 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 duty that may subject him or her to liability. Similarly, enforcement agents and potential private plaintiffs may not find it easy to identify and prove the existence and breach of a fiduciary duty in order to plead and prove a claim. Informational fairness principles in Japanese and German insider trading regulation are largely articulated in the relevant statutory provisions, 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 and administrative or judicial enforcement actions brought by the SEC have attempted to expand the scope of potential liability by adding duties to the pre-existing "list" of protected fiduciary 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 and Mark Cuban are salient examples of these expansive interpretations of U.S. insider trading policy and doctrine.[91]

B. Identifying Insiders and Defining Materiality: The Divergent Development of Two Key Definitional Concepts Involved in Insider Trading Liability

[90] *See* Richard W. Painter at 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.").

[91] *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 AND MARY L. REV. 2209, 2243 (2003) ("[B]by 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).

The policy underpinnings of insider trading regulation in each jurisdiction (as described in Part II.A. above) are important to an understanding of both the overall scope of prohibited activity and the interests the law intends to protect. The substantive and procedural aspects of the regulatory framework should be designed (and, as necessary, interpreted) to effectuate and support the policy objectives underlying the regulation.

Because the policy focus of insider trading regulation may vary from country to country, it is not surprising that differences exist in important features of each country's regulatory scheme. However, variations also may exist among nations that share the same overall policy objective, and these distinctions may illuminate or suggest nuanced differences in underlying policy. As among the United States, Japan, and Germany, two interesting areas for inquiry in this regard are the classification of those deemed to be insiders (i.e., the group of people whose conduct is regulated) and the nature of the information that triggers the insider's duty to refrain from trading until disclosure effectively has been made. This subpart of the paper explores each in turn and highlights the significance of the identified differences.

1. Insiders and Other Regulated Persons

To achieve underlying national policy objectives, operative insider trading law in the U.S., Japan, and Germany regulates a range of conduct engaged in by particular participants involved in or engaged with the market for securities. The market participants whose conduct is regulated under each 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—sometimes referred to as "outsiders") is a person with a direct or derivative duty of trust and confidence emanating from agency law.[92] No effort has been made to define specific positions or relationships that create insider status except through judicial decisions in insider trading cases; however, it is widely acknowledged that key corporate executives, corporate directors, and controlling shareholders—as well as corporate advisors (like lawyers and accountants) typically are considered to be insiders of the corporation they control or serve.[93] Because it is unclear whether U.S. government officials have an agency law fiduciary duty that would be breached by trading or tipping, federal legislation recently was introduced in the United States to provide that (a) members of the executive Branch, Members of Congress, and congressional staff are prohibited from trading on and tipping material nonpublic information and (b) tippees of material nonpublic information obtained from the Executive Branch or Congress also are prohibited from trading.[94]

[92] *See supra* notes 80 & 81 and accompanying text. *See also* Gevurtz, *supra* note 14, at 80-81.
[93] 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.").
[94] *See Brian Introduces Legislation to Prohibit Insider Trading on Capitol Hill*, STATES NEWS SERVICE, Jan. 27, 2009.

"Japanese law on insider trading, codified in the *Shoken Torihikiho*, follows the U.S. statutory and common law schemes in some respects."[95] 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; those who come to know material facts in contracting with the corporation (and the officers, employees, and agents of contracting parties that are entities).[96] This list of regulated individuals and entities includes potential traders who are not regulated under U.S. insider trading law.

> 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.[97]

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 . . . .[98]

Japanese insider trading law does regulate trading by tippees—but only trades made by tippees who receive material nonpublic information directly from insiders.[99] In both

---

[95] 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, 161-162 (2000).

[96] Financial Instruments and Exchange Act, Art. 166(1), Apr. 1, 2008, *available at* http://www.fsa.go.jp/en/refer/legislation/index.html. *See also* Gevurtz, *supra* note 14, 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.").

[97] Gevurtz, *supra* note 14, at 83.

[98] *Id.* at 84.

[99] Financial Instruments and Exchange Act, Art. 166(3), Apr. 1, 2008, *available at* http://www.fsa.go.jp/en/refer/legislation/index.html. *See also* Gevurtz, *supra* note 14, 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.");

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.[100]

German insider trading law takes the broadest approach to this issue, prohibiting (1) the use of material nonpublic information in trading, making trading recommendations, and inducing trading and (2) the tipping of material nonpublic information by any individual or entity.[101] 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.[102] The German conception of insider status seemingly incorporates all those who are insiders under U.S. law and Japanese law.[103] Its breadth 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.[104]

The varied notions of an insider under the insider trading laws of the United States, Japan, and Germany, like distinctions in insider trading policy 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.[105]

It is obvious that the differing descriptions of 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

---

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.").

[100] *See* Gevurtz, *supra* note 14~~14~~, 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.").

[101] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Sections 13 & 14, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* http://www.bafin.de/cln_109/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText18. *See also* Memminger, *supra* note 43, 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.").

[102] *Id.* *See also* Karmel, supra note 50, at 1150-51 (describing primary and secondary insiders under the prior German statutory scheme); Memminger, *supra* note 43, at 205-12 (same); Calaba, *supra* note 49, at 470 (same).

[103] *Cf. id.* at 211-12 (making this point under Germany's prior statute).

[104] Pfeil, *supra* note 49, at 176-77.

[105] *See supra* Part II.A.

and German law.[106] 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.[107]

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 the recognition of a protected agency law fiduciary duty. Accordingly, the earlier described transaction costs arising from the unpredictability and uncertainty associated with the identification of the predicate fiduciary duty are similarly and equally applicable here.[108]

2. Materiality and Other Measures of the 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,[109] more significant questions typically arise as to whether particular facts are material. "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?"[110] Or, conversely, when is nonpublic information used in trading with or tipping others important or significant enough that it will subject the insider trader or tipper and any related tippees to liability?

Under U.S. insider trading law, a fact is material of 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 revelation of the fact will significantly alter the total mix of publicly available information.[111] Material

[106] *See supra* notes 94, 96, 102, and 104 and accompanying text.
[107] *See supra* notes 92, 99, 100, and 103 and accompanying text.
[108] *See supra* notes 89-91 and accompanying text.
[109] [cite]. 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* http://www.bafin.de/cln_109/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText18 (noting that circumstances forming the basis of inside information include "cases which may reasonably be expected to come into existence in the future").
[110] Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763, 824 (1995).
[111] 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 7, at 1137-1138.

information may comprise historical and speculative, contingent, or other forward-looking facts and may be quantitatively or qualitatively important or significant.[112]

> 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."[113]

"[I]nformation 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."[114] Materiality is a mixed question of law and fact and is not generally deemed to be an appropriate subject for summary judgment.[115]

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."[116] 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."[117] The list also may be

[112] *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 111, 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).
[113] United States v. Anderson, 533 F.3d 623, 629 (8th Cir. 2008) (citations omitted).
[114] United States v. Nacchio, 519 F.3d 1140, 1158 (10th Cir. 2008).
[115] Endo v. Albertine, 863 F. Supp. 708, 717 (N.D. Ill. 1994) ("'The Issue 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.").
[116] Financial Instruments and Exchange Act, Art. 166(2), Apr. 1, 2008, *available at* http://www.fsa.go.jp/en/refer/legislation/index.html.
[117] *Id.*

enhanced in certain limited respect by a Cabinet Order prescribing that certain occurrences are material.[118] 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.[119]

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 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." 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 recently 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.[120]

Many countries, however, have not 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.[121] German law is apparently converging toward these materiality formulations, however.

---

[118] *See, e.g.*, *id.* at Art. 166(2)(i)(o), 166(2)(ii)(d), and 166(2)(iii)(h).
[119] Gevurtz, *supra* note 14, at 73-74 (footnotes omitted).
[120] *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?*, Feb. 2, 2009, *available at* http://ssrn.com/abstract=1331511; Jeff Poor, *Gore, Other Apple Directors Face Possible Suit over CEO Jobs' Health*, BUS. & MEDIA INSTIT., Jan. 17, 2009, *available at* http://www.businessandmedia.org/articles/2009/20090117125945.aspx; Dunstan Prial, *Can We Trust What CEOs Say?*, FOXBUSINESS, March 9, 2009, *available at* http://www.foxbusiness.com/story/markets/trust-ceos-say/.
[121] Steinberg, *supra* note 5, 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.").

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

> [i]nside 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.[122]

This statutory definition relies on market price effects as a primary determinant of materiality. Curiously, however, the statute goes on to offer that "[s]uch a likelihood is deemed to exist if a reasonable investor would take the information into account for investment decisions."[123] This latter formulation or guidance was not in earlier versions of the statute[124] and brings the German formulation closer to the U.S. standard.

However, the German statute is more narrow 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."[125] Accordingly, it may be harder to argue that nonpublic personal facts are inside information under the German insider trading law.[126]

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

---

[122] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Section 13, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* http://www.bafin.de/cln_109/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText18.

[123] *Id.*

[124] *See* Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Section 13, Sept. 9, 1998, *available at* http://www.iuscomp.org/gla/statutes/WpHG.htm#13. *See also* Karmel, *supra* note 50, at 1151 (describing the price-effect standard under a prior version of the German statute); Steinberg, *supra* note 5, at 664-65 (same); Calaba, *supra* note 49, at 472 (same).

[125] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz - WpHG*), Part 3, Section 13, Sept. 9, 1998 (last amended Jan. 5, 2007), *available at* http://www.bafin.de/cln_109/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText18. *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* http://www.bafin.de/cln_109/nn_720786/SharedDocs/Aufsichtsrecht/EN/Gesetze/wphg__en.html#doc721676bodyText20 ("[I]nside information directly concerns an issuer if it relates to developments within the issuer's sphere of activity."). *See also* Memminger, *supra* note 49, at 201 (mentioning and explaining, under a prior version of the German statute, this aspect if the definition of inside information).

[126] *See supra* note 120 and accompanying text.

some extent around an investor-oriented perspective of the importance of information possessed by an insider at the time of a trade or shared by the insider in a tip.

Still, 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 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.[127] One can imagine circumstances where personal information about a public company executive officer is (at least arguably) material.[128]

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 and a secondary test gauges importance or significance. The Japanese approach is, perhaps, the most restrictive 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."[129] 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 likely effect is deemed to exist if "a reasonable investor would take the information into account for investment decisions."[130] 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 also then must 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

[127] *See supra* notes 111-115 and accompanying text.
[128] *See*, *e.g.*, Heminway, *supra* note 120, at 759 ("Although personal facts about an executive are less likely to be material than corporate facts, 60 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.").
[129] *See supra* notes 116-120 and accompanying text.
[130] *See supra* notes 122-126 and accompanying text.

defined approaches to determining materiality under Japanese and German insider trading law.[131] Materiality determinations under U.S. law are fraught with uncertainty and unpredictability.[132] Although similar determinations made under Japanese and German insider trading law may not be certain or predictable, the statutes 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), enhancing the prospects for certain and predictable results and limiting transaction costs incurred by transaction and litigation planners.

III. POSSIBLE EXPLANATIONS

Scholars and other commentators have posited a number of reasons for developmental differences in insider trading doctrine and enforcement as among different countries. For example, some have pointed to inherent distinctions between common law nations (e.g., the United States) and civil law nations (e.g., Japan and Germany).[133] Others have noted the obvious differences in public company corporate structure and governance (of which insider trading forms a part) as among nations (including the strong roles of directors in the United States, the prominence of large boards, banks, employee protection incentives, and the *keiretsu* cross-ownership system in Japan, and the key governance positions of banks and labor in Germany).[134] Yet others attribute actual or potential disparities in doctrine and enforcement to differences in the shareholder base of public companies (e.g., disaggregated public shareholders in the United States versus concentrated ownership blocks in Japan and Germany).[135] One author asserts that Japanese variations from the U.S. model may be geared to simplify litigation.[136] A growing group of observers note cultural diversity (variously defined) as a potential cause of national variations.[137] Many of these authors note a cultural ambivalence to insider trading in countries like Japan and Germany.[138] Catalytic events also may explain variations in insider trading doctrine as among nations; the crisis that leads to the adoption of or

[131] *Cf.* Heminway, *supra* note 7, at 1174-82 (describing transaction costs associated with materiality determinations in an insider trading context).
[132] *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.').
[133] [cite].
[134] *See, e.g.*, Nasser, *supra* note 35, at 401-02 (citing to reasons why insiders in Japan are not incentivized to cater to shareholder interests); [more cites].
[135] *See, e.g.*, Gevurtz, *supra* note 14, at 93-96.
[136] *See id.* at 84-85.
[137] Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 160-61 (2001) ("[C]ulture is often invoked as a reason for differences between various national regimes of insider trading regulation. In many countries, such as Japan and Germany, insider trading has been tolerated for a long time as 'part of the game' of securities trading and has not even carried a stigma of being immoral.").
[138] *See* Gevurtz, *supra* note 14, at 85 ("[T]he narrowness of the Japanese prohibition when compared to the United States' misappropriation theory and the EU Directive might appear to be the reaction of a government which was not sure how much it really wanted to enact an insider trading prohibition."); Licht, *supra* note 65, at 160-61 ("Finally, culture is often invoked as a reason for differences between various national regimes of insider trading regulation. In many countries, such as Japan and Germany, insider trading has been tolerated for a long time as 'part of the game' of securities trading and has not even carried a stigma of being immoral.").

changes in insider trading regulation may explain their content.[139] Certainly, the history and timing of the introduction of insider trading regulation in each country (including the importance of Japan's transplantation of U.S. securities laws—including (eventually) insider trading regulation—in the post-World War II era[140] and Germany's late introduction of insider trading regulation in response to pressure from the EC and the United States[141]) play a role and interact with many of the foregoing.

Many of these explanations overlap. All have apparent merit. But none fully explains the extant doctrinal distinctions noted in this paper. Accordingly, this paper posits two additional possible reasons for the noted differences—one based in institutional analysis and one based in policy.

A. Disparities in the Power and Capacity for, and Exercise of, Administrative Discretion

From the comparative observations made about underlying policy, the conception of insider status, and the definition of materiality in Part II, it is easy to detect that U.S. insider trading law is significantly more open-textured than the insider trading laws of Japan and Germany. It is relatively easy (and not inaccurate) to attribute this overall observation to differences between common law and civil law nations. The common law/civil law dichotomy does explain broad-based differences in the laws among countries in many areas.

Yet, the great divide between common and civil law countries does not and cannot fully explain the substantive differences in insider trading regulation described in this paper. For one thing, Japanese and German insider trading doctrine is not the same, and they are both civil law countries. More importantly, however, common law and civil law countries can (and do) take actions to conform their substantive legal rules to each other. A civil law country can closely follow legal doctrine in a common country by codifying the common law rule and amending its statute in response to common law developments in the model country. Although both Japan and Germany have transplanted certain aspects of U.S. insider trading law into their statutes, neither Japan nor Germany has chosen to codify (for example) the U.S. requirement of the breach of a fiduciary duty, the U.S. definition of an insider, or the broad class of information triggering the "disclose or abstain" rule under U.S. law. In addition, a common law country can codify its own common law rules or adopt (with or without statutory codification) rules of other nations, yet the United States has not (1) codified insider trading law in general or (for example) to clarify the need for and contents of any predicate fiduciary duty, to circumscribe the definition of the term "insider," or to define more precisely the nature of material facts or (ii) adopted the substantive insider trading rules of other countries.[142] None of this has

---

[139] *See id.* (noting the possible impact of a current event catalyst on the contents of the Japanese statute).
[140] *See supra* Part I.B.
[141] *See supra* Part I.C.
[142] Gevurtz, *supra* note 14, at 70 ("The source of the prohibition contemplated by, and resulting from, the EU Directive, as well as in Australia, Japan, and, indeed, in most other countries outside the United States, is legislation specifically addressing insider trading. By contrast, for the most part, the prohibition on insider trading in the United States results from administrative and judicial interpretations of a broad anti-

happened in insider trading law as among these three developed nations with well established, mature securities trading markets. Why has it not?

The relative power and capacity of rulemaking and enforcement institutions may play a role in the fundamental differences in the substance of U.S., Japanese, and German insider trading regulation. There is a further story to be told here that builds on the common law/civil law divide—a story about relative longevity, reputation, strength, and expertise of rulemaking and enforcement bodies in the United States and the related ability and desirability of those bodies to attract, preserve, and enhance regulatory and enforcement discretion. Differences in discretion as among the supervisory agencies in each country are matters of degree. "Every governmental and legal system in world history has involved both rules and discretion."[143] The comparisons of insider trading regulation made in this paper indicate that the United States affords significant discretion to the SEC in regulating insider trading; Japan and Germany afford their respective administrative agencies less discretion, with Germany's BaFin having the least (but perhaps a growing) amount of discretion.

Created under Section 4 of the 1934 Act,[144] the SEC has the power to interpret the federal securities laws, make and interpret administrative regulations and rules, inquire about and investigate possible and actual violations of the federal securities laws, and enforce the federal securities laws.[145] Although the SEC currently is under current scrutiny in connection with the global economic crisis and large-scale financial fraud occurring on its watch,[146] it generally has been lavished with praise over the years for its balanced regulatory approach and its expertise.

> [M]ost commentators consider the SEC an extremely successful regulator. . . . The SEC has received repeated praise throughout its almost seventy-year history as a "model agency." It has not acted like the stereotypical regulatory monolith. Defying some administrative theorists, the SEC typically does not blindly seek its own aggrandizement, often ceding substantial regulatory control when doing so serves the best interests of investors and the markets.
>
> But the Commission is seldom an industry lapdog. To the extent that some are still concerned about regulatory capture, the SEC has successfully avoided it. John Coates notes that the SEC has established a record of responsiveness and

---

fraud rule adopted by an administrative agency pursuant to authority under an even broader statutory provision." (footnote omitted)); Nagy, *supra* note 10, at 51 ("Unlike the explicit statutory prohibitions against insider trading that exist in most other countries with developed securities markets, the law of insider trading in the United States is essentially judge-made, turning on whether such trading is deceptive under Rule 10b-5."); Steven R. Salbu, *Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach*, 66 TUL. L. REV. 837, 854 (1992) ("Both the EEC and Japan have developed an [sic] enacted statutory definitions of insider trading, while such attempts in the United States have been thwarted.").

143 KENNETH CULP DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY 17 (1971).

144 15 U.S.C. § 78d (2007).

145 [cite].

146 [cite].

> resistance to bureaucratic inertia such that it "remains a highly respected government agency, even among political constituencies otherwise inclined to doubt the value or abilities of government regulators." Lawyers who deal with the SEC, both in the United States and abroad, indicated in a recent study that they view the agency as both effective and responsive.[147]

Moreover, SEC processes are deemed to be fair and open.[148] As a result, Congress has ceded significant regulatory power to the SEC. The SEC, not Congress, is credited as the watchdog of the U.S. securities markets.[149]

The SEC has been afforded wide rulemaking and enforcement latitude in the area of securities fraud (including insider trading) under Section 10(b) of the 1934 Act. Through the broad pronouncement of Section 10(b), Congress has effectively ceded its regulatory (legislative) power over insider trading to the SEC.[150] Although Congress has modified the statutory framework a bit since 1934 (e.g., by expressly referencing security-based swap agreements),[151] an SEC administrative enforcement action is credited with establishing the "disclose or abstain" rule that defines modern insider trading regulation in the United States, and Department of Justice and SEC administrative and judicial enforcement actions have shaped the broad contours of U.S. insider trading regulation since that time. The SEC adopted two rules under Section 10(b) and Rule 10b-5 in 2000[152] and issued an accounting pronouncement on materiality under Rule 10b-5 the year before.[153] At no time has Congress interfered significantly with the development of insider trading regulation by the SEC and the courts under Section 10(b) and Rule 10b-5. Accordingly, the administrative state and the judiciary retain considerable rulemaking and enforcement discretion over insider trading regulation in the United States, and Congress seems inclined to leave the development of the law of insider trading to the SEC, working hand-in-hand with the judiciary. Although there are plans afoot among scholars and policy makers to change the mandate (and, therefore, the discretion) of the SEC,[154] there are no serious current proposals to restrict the regulatory power and discretion of the SEC over insider trading regulation.

---

[147] Prentice, *supra* note 4, at 800-01 (footnotes omitted).
[148] *Id.* at 802-03.
[149] *Id.* at 830 ("By promulgating and enforcing antifraud rules, the SEC establishes societal standards for market actors. If the SEC prohibits insider trading, people will view it as unacceptable behavior. If the SEC punishes earnings management, economic actors cannot rationalize it as ethically defensible." (footnote omitted)).
[150] 15 U.S.C. § 78j(b) (2007) (prohibiting the use or employment, "in connection with the purchase or sale of any security . . . [of] 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.").
[151] Pub. L.No. 106- 554; § 303(d), 114 Stat. 2763 (2000).
[152] 17 C.F.R. §§ 240.10b5-1 & 10b5-2. For a contextual description of these rules and their application, see Nagy, *supra* note 10, at 37-49.
[153] SEC Staff Accounting Bulletin No. 99, Aug. 12, 1999, *available at* http://www.sec.gov/interps/account/sab99.htm.
[154] [cite].

Both the Japanese Financial Services Agency and the German BaFin are modeled to some extent after the SEC,[155] but neither has the longevity or reputation of the SEC (in general or with respect to insider trading regulation).[156] Moreover, the regulatory powers of each agency historically have been more limited than those granted to the SEC,[157] although these powers have increased and strengthened in the years since the formation of the agencies.[158] In addition, enforcement efforts in Japan and Germany have lagged behind those undertaken by the SEC in the U.S.[159]

Under the circumstances, it does not seem odd that the discretion exercisable by Japanese and German regulatory authorities is further constrained by the more detailed substantive provisions of the Japanese and German insider trading statutes, respectively. Overall, the legislatures in Japan and Germany are unwilling to cede the same level of discretion to the federal agencies with authority over insider trading regulation that the SEC has over insider trading matters in the United States. This differential discretion may account for the observed differences in insider trading regulation in the United States, Japan, and Germany.

In a number of respects, the Japanese insider trading framework occupies a middle ground between the U.S. and German frameworks. The SEC was the first agency to be established as among the three countries; then came the Financial Services Agency, and then the *BAWe* and *BaFin*.[160] Agency enforcement efforts are strongest in the United

---

[155] Prentice, *supra* note 4, at 833-34 ("In recent years, every EU member has created its own version of the SEC, not because of requirements, but because of the obvious success of American capital markets operating under the SEC's protective umbrella. The United Kingdom has created the Financial Services Authority (FSA), Germany the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin), France the Autorite des Marches Financiers (AMF), and Spain the Comision Nacional del Mercado de Valores (CNMV). Asian nations have followed suit. For example, China has created the China Securities Regulatory Commission (CSRC), Japan the Financial Services Agency (FSA), and South Korea the Financial Supervisory Commission (FSC)." (footnotes omitted)).

[156] Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9, 23 (1999) (noting that "[t]he last major market center to adopt the Insider Trading Directive was Germany, and this delay happened in part because Germany had no viable regulator to administer this law.").

[157] *See* Robert G. Miller, *Comparing the Annual Shareholders Meeting in the United States with that in Germany - Use of Yankee Concepts of Due Process Discerned by Alexis de Tocqueville*, 19 N.Y.L. SCH. J. INT'L & COMP. L. 1, 102-104 (1999) (comparing and contrasting U.S. and German models of administrative securities regulation); Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931, 1013 n.342 (2003) ("Even with regards to insider trading, the law enforcement powers of the BAW were quite limited. They included monitoring, such as the right to request additional information from likely violators. Investigations of and punishment for share price manipulations were not part of its portfolio."); Naidu, *supra* note 59, at 300 ("Enforcement of securities laws in Germany is constrained by the limited authority and resources delegated to the BAWe. The BAWe has only fourteen investigators, and German law does not authorize the BAWe to implement penalties for manipulation of the market or other violations. Rather, only the [Lander] have the authority to punish violators of securities laws, but their familiarity with this field is limited."); [cites re. Japan].

[158] Thomas J. Andre, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 117 (1998) (describing enhancements to the regulatory powers of federal securities regulators in Germany); Pfeil, *supra* note 49, at 166 (noting the broad surveillance, investigatory, and enforcement power of BaFin's predecessor agency).

[159] [cite].

[160] [cite].

States, less strong in Japan, and least strong in Germany.[161] U.S. and Japanese insider trading regulation share common policy roots in equal access informational fairness (although the United States allows that policy consideration to be trumped by its policy of protecting agency law fiduciary duties first and foremost); Japanese and German insider trading regulation share common primary policy roots in informational fairness, although Japan has an equal access objective and Germany has a parity of information objective.[162] Conceptions of insider status and materiality are expressed through open standards in United States insider trading doctrine, and through more definitive rules in Japan and Germany (with Germany having the most definitive rules affording the least administrative discretion).[163]

If a desire to limit discretion does motivate differences in insider trading regulation, then we would expect that, as Japan's Financial Services Agency and Germany's BaFin develop a stronger reputation through, for example) a more expansive use of their existing regulatory and enforcement powers, additional power and discretion will be afforded to them by the legislatures in their respective countries. This phenomenon already may be occurring; a desire to increase discretion may, for example, explain the recent amendment of the German insider trading statute to include a less restrictive interpretation of the "price-effect" test for materiality (based on the likelihood of use of the information by a "reasonable investor").[164]

B. Different Conceptions of Informational Fairness Driven by History, Culture, and Market Forces

Differing notions of fairness promoted by rule makers in the United States, Japan, and Germany explain the observed differences in insider trading regulation among the three countries. Fairness is a somewhat slippery concept,[165] and so it requires some definition. According to the *Merriam-Webster Online Dictionary*, the root adjective "fair" means (in relevant part) "marked by impartiality and honesty" or "free from self-interest, prejudice,

---

[161] [cite].
[162] [cite].
[163] [cite].
[164] [cite].
[165] Jeffrey L. Dunoff, *Fairness in the World Economy: US Perspectives on International Trade Relations*, 101 A.J.I.L. 907, 908 (2007) (Book Review) ("Fairness is an multifaceted concept with many dimensions and many meanings"). Fairness may be a personal moral issue, for example.

> It is not completely clear what people believe is fair from the standpoint of personal morality. Not long after announcement of the Boesky case, a public opinion poll was published showing that, while most people believed insider trading should be illegal, most people also would do it themselves if they had the chance. This may simply be a confession of weakness, but it may also reflect a feeling that such trading is not really wrong in itself, however desirable its prohibition may be as social policy.

Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 358 (1988). Or fairness may be coextensive with consensual agreement, untainted by duress or deception. *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.").

or favoritism" or "conforming with the established rules."[166] Fairness may be seen as synonymous with equity—but not with equality (although equal treatment may sometimes be fair).[167] Some or all notions of fairness may be flawed; but they each have proponents as well as detractors, and in the hands of rule makers, they may present a more understandable explanation for variations in insider trading laws among nations.

The Supreme Court is credited with overruling fairness as a policy basis for U.S. insider trading regulation in the *Chiarella* and *Dirks* cases,[168] but it is possible to view the Court's decisions in *Chiarella* and *Dirks* as merely rewriting the policy analysis to focus on a different conception of fairness. In fact, critics of U.S. insider trading regulation often characterize its rules or results as unfair.[169] However, it may be more accurate to say that those rules or results are fair in a different (and, in the critic's view, less acceptable) way. Professor Kimberly Krawiec cogently expresses the fairness policy underlying current U.S. insider trading regulation.

> 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

---

[166] Merriam-Webster Online Dictionary, March 22, 2009, *available at* http://www.merriam-webster.com/dictionary/fair.
[167] [cite].
[168] *See, e.g.*, Greenberg, *supra* note 165, at 307.
[169] For example, one commentator writes:

> 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).

> permitted to trade on that information without disclosure to their trading partners.[170]

Another recognized form of fairness 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.[171] Japan's insider trading rules continue to be premised on this type of fairness. The fairness of an equal access rule, like that underlying Japan's insider trading statute, can be explained in a manner similar to that used to explain the fairness of the fiduciary duty rule in the United States.

> [E]quality of access advocates maintain that informational advantages that cannot be lawfully eroded through the expenditure of sufficient time and effort should be prohibited. . . . Because informational 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, there is no romantic author whose skill and effort must be rewarded with permission to profit from her inside information. 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.[172]

---

[170] 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).

[171] Dunoff, *supra* note 165, 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.'").

[172] *Id.* at 476-77 (footnotes omitted). *See also* Cox & Fogarty, *supra* note 165, 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.").

Although neither the fiduciary duty rationale nor the equal access rationale helps the investor who believes that she is being treated inequitably because others in the market have an information advantage over her,[173] each rationale expresses a different—but equally valid—conception of fairness.

The parity of information policy that underlies the German insider trading statute is the most helpful to the disadvantaged investor and the easiest type of fairness to explain. Here, equity is based not on an equal access or availability to information but, rather, on an equal awareness of information.

> 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.[174]

These three different conceptions of fairness do, indeed, explain key variations in insider trading regulation in the three countries. Each nation's policy reference point and the relate definition of insider status is tied to its individualized fairness conception.[175] But this analysis begs the question of why each country's rule maker would base the nation's insider trading regulation on a different notion of fairness. Is there a cultural connection, in each case, for example, to the conception of fairness underlying each country's insider trading doctrine? Or do market forces play a leading role? It is likely that both culture and context jointly impact the judgments of rule makers.[176]

The notion of fairness operative in the United States encourages significant entrepreneurial information markets, since only those market participants with agency law fiduciary duties are prohibited from trading in or tipping important information about a company's securities. In a perfect world under the semi-strong version of the Efficient Capital Market Hypothesis, although those who work hard to amass information may profit most directly from their own efforts, this entrepreneurial market supplements issuer mandatory disclosures and helps ensure a more well informed, well priced market for securities.[177]

---

[173] To this point, Professor Krawiec notes that

> [a]~~A~~n 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 170, at 479.

[174] Cox & Fogarty, *supra* note 165, at 359.

[175] Differences in materiality doctrine are not, however, easily attributed to different conceptions of fairness.

[176] Small, *supra* note 42, at 1455 ("Law is a product of its context as well as its culture.").

[177] [cite].

Japan historically has not needed to encourage the development of such a broad and healthy market for information, since large block shareholders already were serving this function in the Japanese stock markets.[178] Presumably, market prices for securities take into account both the information added to the market by these large shareholders and any discount associated with the market advantages of the large block holders. Because block shareholders would not typically be insiders for purposes of Japan's insider trading laws (absent, e.g., the negotiation or conclusion of a contract with the issuer or the exercise of rights of inspection of the issuer's account books) , the Japanese conception of fairness can afford to be more expansive without changing the relationship among established market participants.

One would presume that Germany, also a country with historically large block holders of securities, would adopt the same notion of fairness earlier adopted in Japan. In fact, until 2002, the German statute was based on equal access informational fairness (although under the German statute, block shareholders with unequal access to information were insiders).[179] In [2002], Germany amended its insider trading statute to reflect parity of information fairness. This change apparently was prompted by a need to restore confidence in Germany's securities markets as part of a program to diversify the ownership of German public companies.[180]

CONCLUSION

This paper briefly outlines the common roots and divergent development of three national insider trading regimes and endeavors to explain both the significance and bases for observed differences in several key regulatory areas.

Insider trading regulation, built on the "disclose or abstain" rule first endorsed by the SEC in the United States in 1961 and administered under the auspices of a federal agency resembling the SEC, is a part of the legal fabric in developed and developing nations around the world.[181] Yet, apart from their common roots and cores, insider trading rules vary from country to country.

> "The global interest in regulating insider trading stems from the necessity of accurate risk assessments and confidence in financial markets." If insiders are allowed to take advantage of their privileged information, risk assessments of the insiders and non-insiders could vary significantly and weaken the confidence of anyone not privy to the inside information. Although the concept of prohibiting insider trading is widely accepted, the world does not have a common standard for

[178] *See*, *e.g.*, Nasser, *supra* note 35, at 402-04.
[179] Securities Trading Act (*Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz* - *WpHG*), Part 3, Section 13(1), Sept. 9, 1998, *available at* http://www.iuscomp.org/gla/statutes/WpHG.htm#13.
[180] Jack Ewing, *Luring German Investors Back into the Pool*, BUSINESSWEEKONLINE, Apr. 12, 2004, available at http://www.businessweek.com/magazine/content/04_15/b3878157_mz035.htm.
[181] Prentice, *supra* note 4, at 837-38.

> deterring such activity mainly because of the different definitions of insider trading.[182]

Among other things, the insider trading laws in the United States, Japan, and Germany have different policy underpinnings, regulate trading and tipping by different people, and define the concept of materiality differently. These variations are important in that they may be outcome determinative and create different transaction costs for transaction and litigation planners.

Many overlapping and intertwined factors may explain the different operative insider trading policies and rules in the three countries. This paper extends the growing literature that attempts to explain these differences by suggesting that differences in agency power and discretion and the conscious adoption of different notions of fairness may help explain the observed distinctions among U.S., Japanese, and German insider trading doctrine.

[182] Dafei Chen, Note: *Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Banking Crisis, the Current Situation and a Future Perspective*, 9 MINN. J. GLOBAL TRADE 269, 293 (2000).