WITH THE SPOTLIGHT ON THE FINANCIAL CRISIS, REGULATORY LOOPHOLES, AND HEDGE FUNDS, HOW SHOULD HEDGE FUNDS COMPLY WITH THE INSIDER TRADING LAWS?

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I. INTRODUCTION

Since 2007, when it commissioned a working group to investigate insider trading in the hedge fund industry,[1] the U.S. Securities and Exchange Commission ("SEC") has leveled particular scrutiny at insider trading by hedge funds. Accordingly, it issued subpoenas to over fifty hedge fund advisers in July 2008.[2] The SEC is not alone in this pursuit.

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[1] *Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2007/ts073107cc.htm.

[2] Pratish Narayanan, *SEC Subpoenas Over 50 Hedge-Fund Advisers: Report*, REUTERS, July 15, 2008, *available at* http://www.reuters.com/article/ousiv/idUSBNG13848820080715.

On June 19, 2008, the Federal Bureau of Investigation, in conjunction with the Department of Justice ("DOJ"), arrested two former Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, in connection with the collapse of two Bear Stearns hedge funds.[3] Among other things, the indictment alleges that, while Mr. Cioffi and Mr. Tannin informed investors of a positive outlook, Mr. Cioffi transferred $2 million of his own money, about one-third of his personal position, out of a fund that invested primarily in collateralized debt obligations ("CDOs").[4] In addition to charges for securities and wire fraud, Mr. Cioffi has been charged with insider trading.[5]

Despite this increased scrutiny, no market practice has developed to assist hedge funds in complying with insider trading laws and to offer them the protection of collectively conforming to commonly accepted norms.[6] To help fill this void, this Article proposes guidance on insider trading compliance for hedge funds and other institutional traders with similar concerns. Unlike the vast majority of the literature on insider trading, the focus of this Article is risk reduction and prevention rather than litigation or academic analysis. In particular, it considers how hedge fund compliance policies should take account of derivative and

[3] Kate Kelly, *Prosecutors in Bear Case Focus in on Email*, WALL ST. J., June 19, 2008, at A1. SEC has also charged Mr. Cioffi and Mr. Tannin with fraudulently misleading investors. Press Release, SEC, SEC Charges Two Former Bear Stearns Hedge Fund Managers with Fraud (June 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-115.htm.

[4] *See* United States v. Cioffi, No. 08-415 (E.D.N.Y. June 18, 2008); Press Release, U.S. Dep't of Justice, Two Senior Managers of Failed Bear Stearns Hedge Funds Indicted on Conspiracy and Fraud Charges: Investor Losses Total More Than $1 Billion (June 19, 2008), *available at* http://www.usdoj.gov/usao/nye/pr/2008/2008jun19.html.

[5] Cioffi, No. 08-415.

[6] In response to a question about market practice relating to hedge funds' compliance with the insider trading laws, we polled a number of partners at Jones Day, some of whom also contacted hedge fund clients. We reached the conclusion that such market practice does not really exist. Indeed, one hedge fund offered to speak to another hedge fund, because the idea of sharing practice and analysis was attractive to it.

debt securities as well as the globalization of securities markets. Both of these areas present interesting legal issues in an evolving context of recent market and legal developments. For the many hedge funds that are highly active traders of debt and derivative securities in global markets, both of these areas are of special concern.

Since insider trading was traditionally limited to common stock,[7] special issues are posed by derivative and debt securities, such as options and high yield bonds, known as "equity in drag." In light of the emergence of complex securities that have equity characteristics, the SEC has sought to extend insider trading enforcement to the markets for derivative and debt securities. The applicability of insider trading restrictions to options trading was initially uncertain under the prevailing case law, but this doubt has largely been dispelled by legislation.

However, the insider trading legislation for options has not been transposed to debt and certain derivatives, such as the credit-default swaps ("CDSs") at the heart of the current financial crisis. Insider trading violations are less clear in these areas, because the "classical" and "misappropriation" theories of insider trading under the existing case law may not apply. The classical theory of insider trading only reaches corporate insiders and others with a fiduciary duty to the issuer's shareholders.[8] Holders of bonds and derivatives do not have such a duty (unless, perhaps, they are also shareholders). Under the misappropriation theory, the recipient of inside information must, directly or indirectly, owe a duty to the source of the information, such as the issuer or a corporate insider with a fiduciary duty to

[7] *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1216 (1995) ("In sum, the disclose or abstain rule should not apply to insider trading in debt securities."); Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities*, 49 BUS. LAW. 187, 187 (1993) (citing other sources in support of the observation that "[n]ot too long ago, conventional wisdom held that insider trading regulation was limited to the equity markets").

[8] *See infra* Part II.C.

the issuer.[9] This duty will be absent in the case of a holder of a bond or derivative who has no obligation or relationship of confidentiality to the issuer or a tipper.

The following four hypotheticals are commonplace and illustrative. In the first, a hedge fund is solicited by an underwriter or other broker-dealer to participate as a qualified institutional buyer ("QIB") in a Rule 144A private placement of debt. In the second, a broker or another QIB informs the hedge fund that a company is planning a Rule 144A private placement of debt despite the refusal of the hedge fund to be bound by any confidentiality restrictions. In the third and fourth, the scenarios are the same as the first and second hypotheticals, except that the private placement is a private investment in public equity ("PIPE") involving common or preferred stock, such as the many such transactions currently being done by banks. Under any of these hypotheticals, does the hedge fund possess inside information prohibiting it from trading in the subject company's securities? If such a trade does occur, has the hedge fund violated the classical or misappropriation theories of insider trading? What about the underwriter, the broker, or the other QIB? Are the answers to these questions different in the United States and Europe?

Globalization poses special issues for hedge funds. First, hedge funds may become subject to regulation by multiple jurisdictions. Second, hedge funds may be able to avoid the application of the U.S. securities laws but still earn excellent profits if they trade in foreign markets that are sufficiently liquid in comparison to U.S. markets.

Put differently, globalization means that, to reduce the costs of following insider trading laws and the risks from failing to do so, international hedge funds have an interest in promoting regulatory consistency and harmonizing compliance practices across jurisdictions. Nevertheless, globalization also means that international hedge funds may perceive the opportunity to "forum shop" by choosing to trade in jurisdictions with amenable insider trading rules. For

[9] *See infra* Part II.E.

these reasons, and because of the influence of U.S. insider trading regulation in other countries, an international perspective informs understanding of global capital markets and how they will or should evolve.

This Article is divided into four principal sections, each of which responds to a fundamental question about insider trading compliance for hedge funds.

Part II—*From a compliance perspective, what is the law on insider trading?*—analyzes how hedge funds should address legal loopholes in the law of insider trading, including loopholes applicable to debt securities, credit default swaps and other derivative securities.

Part III—*Why must a hedge fund have an insider trading compliance policy?*—considers how hedge funds should respond to the recent circuit court decision overturning a new SEC rule that required hedge funds to have an insider trading compliance policy.

Part IV—*What compliance policies and practices should be implemented in a hedge fund's insider trading program?*—provides practical advice on how in-house lawyers and other compliance personnel at hedge funds should interact with traders to identify, manage, and resolve insider trading issues regarding the definition of material, inside information. Examines whether hedge funds (i) should engage in whistleblowing of insider trading violations, (ii) are able to use Chinese Walls as an insider trading solution and (iii) can take advantage of big boy letters after the recent decisions and debate on the efficacy of these letters.

Part V—*How should insider trading be understood in light of the globalization of capital markets?*—investigates the potential risks, opportunities, and insights relating to the interconnectedness of U.S. and foreign insider trading laws, especially the European Market Abuse Directive.

II. FROM A COMPLIANCE PERSPECTIVE, WHAT IS THE LAW ON INSIDER TRADING?

The development of U.S. insider trading law is a long, convoluted and, at least for lawyers, fascinating story. It presents a classic illustration of the common law method

whereby legal rules emerge from case-by-case decisions with respect to specific fact patterns. The frequent retelling of this story among lawyers, and the common law approach, has led to a belief that a full comprehension of the story is necessary to understand the law on insider trading. In other words, the perception is that the question of what constitutes insider trading has a complicated answer.

In contrast, this Article argues that the answer to this question, for hedge funds, not only must be, but is, relatively simple in principle. Unlike defendants' attorneys, the ultimate masters of after-the-fact damage control, in-house lawyers and other compliance personnel at hedge funds do not have the luxury of immersing themselves in the intricacies of insider trading law as it may apply to cleverly distinguishable cases or the role of creating doubt in favor of a defendant. Rather, focused on prevention before the fact, in-house lawyers want compliance policies to respond to Lenin's famous question, "What to do?"[10] and to enable the hedge fund's traders to, like Nike fans, "just do it." In particular, lengthy analysis of insider trading rules is not useful for traders at hedge funds, who do not have the time, inclination or legal training to completely assimilate such information. One alternative—frequent consultation of traders with lawyers—is impractical both in terms of cost and operations management. Moreover, effective implementation of this alternative would still require that lawyers be able to provide straightforward, conclusory advice to traders.

In essence, the United States' complex laws on insider trading highlight the commonly criticized deficiencies of a common law approach: the inaccessibility of the law to non-lawyers and lack of a clear, systemic code of conduct. As indicated below, the European Market Abuse Directive,[11] which reflects a civil law approach, is better suited to the

[10] VLADIMIR LENIN, ESSENTIAL WORKS OF LENIN: "WHAT IS TO BE DONE?" AND OTHER WRITINGS (Dover Publications 1987) (1902). Opinions differ on the translation of the title.

[11] Council Directive 2003/6, 2003 O.J. (L 96) 16 [hereinafter *Market Abuse Directive*].

needs of those responsible for compliance at hedge funds. Fortunately, because this regulation was strongly inspired by U.S. insider trading law, it also enjoys an advantage of the U.S. common law approach: the careful, quasi-scientific, elaboration of the law from the "laboratory" of real life experience rather than theoretical, deductive reasoning. The Market Abuse Directive therefore represents a useful source of reference for thinking about how U.S. insider trading law might be codified for purposes of a compliance policy and what should be considered "best practices" in any case, whether or not strictly punishable by law.

Nevertheless, this Article proposes that, even without seeking inspiration or confirmation in European law, we can glean a simple precept from the history of U.S. insider trading regulation to formulate the basis for hedge fund compliance policies. This precept is that a person with material, inside information[12] must disclose it or refrain from trading. The discussion below shows how this precept has guided SEC enforcement and regulation over the course of more than four decades and become accepted as economically and equitably justified.

A. The Statutory Basis for the Insider Trading Laws

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") prohibits the use of any deceptive device in connection with the purchase or sale of securities.[13] Based

[12] The SEC and the case law tend to use the term "nonpublic information." This Article instead uses the term "inside information," because it more accurately defines the basis for the disclose or refrain from trading principle. As further explained, *infra* Part II.F.2, neither the SEC nor the insider trading laws seek to restrict a person from trading on the basis of material, non-public information that such person has primarily created, instead of obtained from privileged inside access. For example, a person may do so by piecing immaterial, non-public data together with public information or analyzing readily observable characteristics in the markets, such as those indicating whether a public company may be the target of an acquisition.

[13] Specifically, in pertinent part, Section 10(b) provides:

on the language "registered on a national securities exchange or any security not so registered," courts have held that Congress intended Section 10(b) to apply to all purchases and sales of securities, even if the security is only thinly or privately traded. For example, it applies to the sale of 100% of the stock of a closely held corporation,[14] a private placement of securities[15] and the trading of securities in the "pink sheets."[16]

Pursuant to rulemaking authority granted under Section 10(b), the SEC adopted Rule 10b-5. In pertinent part, this rule makes it unlawful to "employ any device, scheme, or artifice to defraud," or "[t]o engage in any act, practice, or course of business which operates or would operate as a

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> It shall be unlawful for any person, directly or indirectly . . .
>
> > (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), 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.

Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006).

[14] *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); *see also* SEC v. Nat'l Presto Indus., Inc., 486 F.3d 305, 309-10 (7th Cir. 2007) (reaffirming the *Landreth Timber* holding that the securities laws apply to the sale of all the stock in a closely held corporation and concluding that "*Landreth Timber* represents the norm in securities law").

[15] *See In re* Paul Y. Okuda, Securities Act Release No. 7792, Exchange Act Release No. 42,339 (Jan. 13, 2000) (applying Section 10(b) to a private placement of unregistered securities), *available at* http://www.sec.gov/litigation/admin/34-42339.htm.

[16] *See* Binder v. Gillespie, 184 F.3d 1059 (9th Cir. 1999) (applying section 10(b) to a "pink sheet" stock, but finding that a security's status as being traded in the "pink sheets" alone is insufficient to establish that the stock is actively traded in an "efficient market" in order to show "fraud on the market").

fraud or deceit upon any person in connection with the purchase or sale of any security."[17]

Rule 10b-5 prohibits not only affirmative misrepresentations, but also nondisclosure of material information in connection with a purchase or sale of a security. However, in delimiting the scope of Rule 10b-5, the courts have more readily found violations of it in the context of affirmative misrepresentations rather than nondisclosure. A person may be allowed not to comment, but is not permitted to make a comment that is misleading, whether by falsity or by omission.[18]

Strictly defined, insider trading only concerns nondisclosure.[19] The classic instance is a secondary trade with an unknown counterparty in a securities market. Nonetheless, broadly conceived, insider trading may be

[17] 17 C.F.R. § 240.10b-5 (2008). The SEC may also bring insider trading charges under Section 17(a) of the Securities Act of 1933, which prohibits similar conduct as Rule 10b-5 of the Exchange Act. 15 U.S.C. § 77q (2006). Differences between Rule 10b-5 and Section 17(a) include: (1) Section 17(a) applies to the "*offer or sale* of any securities," while Rule 10b-5 applies "in connection with the *purchase or sale* of a security" and (2) unlike Rule 10b-5, Section 17(a) does not have an "implied-private right of action" (emphasis added). *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 575 (1978). Both Section 17(a)(1) and Rule 10b-5 require the proof of *scienter*, but Section 17(a)(2) and (3) do not require proof of *scienter*. *See* Aaron v. SEC, 446 U.S. 680 (1980).

[18] *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224 (1988) (concluding that publicly denying the possibility of a merger that is later consummated may give rise to Rule 10b-5 liability, but only if the information given or the denial was "material" and that there is no bright line test for materiality—it depends on the facts of each case); *In re* E.ON AG, Exchange Act Release No. 43,372 (Sept. 28, 2000) (finding that E.ON AG could legally refuse to comment on merger rumors, but its false public denials of the existence of merger discussions were material and thus actionable under Rule 10b-5).

[19] *See, e.g.*, Deutschman v. Beneficial Corp., 841 F.2d 502, 506 (3d Cir. 1988) (noting that *Chiarella v. United States* and *Dirks v. SEC* "dealt not with injury caused by affirmative misrepresentations which affected the market price of securities, but with the analytically distinct problem of trading on undisclosed information . . . "); Chiarella v. United States, 445 U.S. 222, 226 (1980) (analyzing whether silence violates Section 10(b) of the Exchange Act).

attacked and sanctioned on the grounds of affirmative misrepresentations.[20] That is, although not limited by the case law on insider trading, a claim of affirmative misrepresentations may be made against a trader that has communicated some information to a counterparty, but in doing so has omitted material, non-public information.

B. SEC Enforcement Actions Against Insider Trading

As compared to a Rule 10b-5 claim for affirmative misrepresentations, a claim for nondisclosure is more difficult for a plaintiff to establish, because the latter requires a finding of a duty to disclose. Thus, descriptions of insider trading law typically explain the complex manner in which the definition of this duty has been changed and developed on a case-by-case basis over a number of years. However, this focus is misplaced from a compliance perspective.

The motivations behind SEC enforcement actions, instead of court decisions, should be the primary concern of compliance officers, in-house lawyers, and traders at hedge funds. Unless it is quickly dismissed, an SEC enforcement action will be a costly problem for a hedge fund and its personnel, entailing significant legal expense, diversion of senior time and attention, and reputational risk even if the SEC ultimately loses on the merits. Moreover, the SEC's conception of insider trading transgressions determines not only its enforcement actions, but its efforts to convince courts to extend the reach of the insider trading laws in general and in particular cases.

As the evolving case law shows, these efforts have frequently, if not predominantly, been successful. Time and time again, the SEC has discovered ways to punish conduct that it considers objectionable, even though it is seemingly defensible under the existing "black letter" case law. To the chagrin of defendants hoping to rely on such law for absolution, the SEC has discovered:

[20] *See, e.g., Deutschman*, 841 F.2d at 508.

1. creative arguments that effectively change the law to the detriment of defendants;

2. facts that take the claims outside of its limitations; or

3. alternative legal theories that work around them.[21]

A good compliance program cannot count on the rare good fortune that a court might side with a defendant instead of the SEC, but must instead strive to prevent SEC enforcement in the first place.

Unlike court decisions, SEC enforcement has been guided by a simple, uniform principle: disclose material, inside information or refrain from trading. This principle was enunciated in the SEC's first insider trading prosecution in 1961[22] and continued to be the essential statement of insider trading law until the Supreme Court's *Chiarella* decision in 1980.[23]

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[21] In *Chiarella v. United States*, the Supreme Court found that a financial printer employee did not engage in insider trading when he deduced, from information available to him at his work, the identities of companies that were involved in possible public takeover bids and traded on the basis of this information. 445 U.S. 222 (1980). In *United States v. O'Hagan*, 521 U.S. 642, 661-62 (1997), and *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), a financial printer employee in the same situation was found guilty of insider trading. The Eighth Circuit, and the author of a law review article on the subject, did not consider a lawyer to be in violation of the insider trading laws when he traded on the basis of information about public takeovers that he learned at his firm, but not from clients or transactions with which he was involved. United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996); Bainbridge, *supra* note 7 at 1198. As further explained in Part II.E, *infra*, however, the Supreme Court overturned the Eighth Circuit's ruling in *O'Hagan*. United States v. *O'Hagan*, 521 U.S. 642 (1997). In *SEC v. Barclays Bank PLC*, No. 07 CV 4427 (S.D.N.Y. May 30, 2007), further discussed in Part II.E., *infra*, an investment bank and trader had to pay significant fines for insider trading in debt securities, even though the traditional view was that debt securities were not covered under the Supreme Court's case law on insider trading.

[22] *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[23] *See, e.g.*, Selective Disclosure and Insider Trading, Securities Act Release No. 33-7787, Exchange Act Release No. 34-42259, 64 Fed. Reg.

C. The Classical Theory of Insider Trading and Rule 14e-3

In *Chiarella*, the Court held that "there is no general duty to disclose before trading on material non-public information . . . . Such a duty arises rather from the existence of a fiduciary relationship."[24]

Officers and directors of a corporation clearly owe a fiduciary duty to its shareholders. Under traditional state law, if a shareholder owns more than 50% of a corporation or, under certain exceptional circumstances, if a shareholder owns a significant controlling interest (e.g., 40%) and exercises actual control over the corporation, then the controlling shareholder has a fiduciary duty.[25] However, a corporation's investment bankers, lawyers, accountants, and financial printers, as well as potential acquirers and their advisers, arguably had no such duty, at least under traditional state law at the time of *Chiarella*.[26] Nonetheless,

72,590, 72,593 (Dec. 28, 1999) (noting that early insider trading case law appeared to require that traders have equal access to corporate information) (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

[24] Dirks v. SEC, 463 U.S. 646, 654 (1983) (referring to *Chiarella*, 445 U.S. 222). The *Chiarella* Court's fiduciary relationship requirement is founded in its interpretation of Section 10(b) of the Exchange Act. Starting with the language of Section 10(b) and Rule 10b-5, the *Chiarella* Court remarks that neither the statute nor the rule states whether nondisclosure may constitute a manipulative or deceptive device. *See Chiarella*, 445 U.S. at 226. The Court observes that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." *Id.* at 234-35. Referring to past administrative and judicial interpretations to determine what is intended to fall within the statute's notion of fraud, the Court finds that a duty to disclose is the element required to make silence fraudulent. *Id.* at 232. The Court considers it "established doctrine" that such duty arises from a specific relationship of trust and confidence between two parties. *Id.* at 233. It refuses, in the absence of specific language or other explicit indication of congressional intent, to recognize a general duty between all participants in market transactions to forgo actions based on material, non-public information. *Id.*

[25] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1269-70 (2008).

[26] *See* Bainbridge, *supra* note 7.

strong regret potentially awaited any of them who might have wished to rely on *Chiarella*.[27] The decision did not stop the SEC from continuing to bring insider trading cases against these kinds of defendants. Though the SEC tried, but failed to regain the courts' general acceptance of its definition of insider trading, it gradually but surely got the courts to apply it to a large range of defendants in a wide variety of situations.

The SEC's refusal to acquiesce to the *Chiarella* decision was immediately signaled by its enactment of Rule 14e-3 in 1980. In the context of tender offers, this rule effectively removes *Chiarella's* fiduciary duty condition for an insider trading violation.[28] Instead, it reflects the SEC's position that persons should disclose material, inside information or refrain from trading. Specifically, the rule prohibits a tippee from trading in the tender offer context if it has reason to know that it possesses material, non-public information that was directly or indirectly acquired from the potential acquirer, the target company, or any other person acting on behalf of either of them.[29] The rule also makes it unlawful for

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[27] *See Chiarella*, 445 U.S. 222. "The SEC and the lower courts seem to view the fiduciary duty element as a mere minor inconvenience that should not stand in the way of expansive insider trading liability. They have consistently sought to evade the spirit of the fiduciary duty requirement, while complying with its letter." Bainbridge, *supra* note 7, at 1198.

[28] *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 669 (1997).

[29] 17 C.F.R. § 240.14e-3(a) (2008). The rule states:

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
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> 1. The offering person,
> 2. The issuer of the securities sought or to be sought by such tender offer, or

a tipper to communicate such information to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of Rule 14e-3, subject to specified exceptions.[30] Resolving doubts that *Chiarella* raised about the SEC's authority to enact Rule 14e-3, the Supreme Court confirmed Rule 14e-3's validity in *O'Hagan*.[31]

Promptly after the *Chiarella* decision, the SEC brought suit seeking to limit its applicability to a narrow set of facts.[32] In *Dirks*, decided by the Supreme Court in 1983, the SEC's position was rejected and the relevance of *Chiarella* reaffirmed. Nevertheless, this defeat proved to be more tactical than strategic for the SEC. Commentary in *Dirks* served to significantly re-expand the reach of the insider trading laws. Based on a footnote in *Dirks*, the courts developed a concept of a temporary or constructive fiduciary,

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> 3. Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

Id.

[30] Rule 14e-3 does not apply to communications made in good faith to:

> (1) an officer, director, partner, or employee of the offeror, or anyone involved with the tender offer; (2) the issuer whose securities are sought by tender offer, its officers, directors, partners, employees or advisors, or anyone involved with the tender offer; or (3) any person pursuant to the requirement of a statute, rule, regulation, etc.

See 17 C.F.R. § 240.14e-3(d)(1) (2008).

[31] *O'Hagan*, 521 U.S. at 669.

[32] Dirks v. SEC, 463 U.S. 646 (1983). Specifically, the SEC argued that the holding of *Chiarella* should be restricted to cases involving not inside information, but rather "market" information, i.e., "information generated with the company relating to its assets or earnings." *Id.* at 656 n.15.

so that investment bankers, lawyers, and accountants of a corporation were constrained from trading on non-public information regarding it.[33]

D. The Tippee Theory of Insider Trading

Dirks also provided justification for imposing the insider trading laws on "tippees" that, directly or indirectly, received material, non-public information from permanent or temporary fiduciaries. The *Dirks* court did not go so far as to accept the SEC's position that a tippee inherits the tipper insider's fiduciary duty to shareholders,[34] but opened up a line of reasoning in subsequent decisions that has gone a long way towards this position. It postulated that a tippee assumes an insider's duty if inside information was made available to it improperly and it knew, or should have known, of such impropriety.[35] A tipper's revelation to a tippee constitutes an improper breach of fiduciary duty if the tipper will receive direct or indirect personal benefit from it, such as a pecuniary gain or reputational benefit that will translate into future earnings.[36] Such a breach also occurs if the revelation amounts to a gift to a relative or friend.[37] In divulging material, inside information to an outsider for an improper purpose, the tipper, as well as the tippee who trades on it, commit an insider trading violation.[38]

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[33] *Id.* at 655 n.14.

[34] *Id.* at 655.

[35] *Id.* at 660.

[36] *Id.* at 663.

[37] *Id.* at 664.

[38] *See, e.g.*, SEC v. Stevens, Litig. Release No. 12813, 48 SEC Docket 739 (Mar. 19, 1991). *See also Dirks*, 463 U.S. at 659 ("Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (one of the first cases to extend insider trading liability to the tipper).

E. The Misappropriation Theory of Insider Trading

While pursuing efforts to widen the scope of *Chiarella*'s fiduciary duty to apply to additional types of defendants, the SEC also developed a creative new theory of insider trading that it persuaded the Supreme Court to adopt in *O'Hagan*.[39] Under this misappropriation theory of insider trading, a person violates Rule 10b-5 if he "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[40] Thus, a lawyer was found guilty of insider trading for misappropriating from his law firm material, non-public information about a tender offer, even though he himself did not work on the transaction for the law firm's bidder client and owed no fiduciary duty to the target corporation (or bidder).[41] In addition, a court recently held that an outsider who obtained material, non-public information in his capacity as a director for a large shareholder of the originating source may be held liable because the misappropriation theory is not limited to "originating sources."[42]

More significantly, the SEC has recently used the misappropriation theory to successfully sanction insider trading of debt securities. In *SEC v. Barclays Bank PLC*, Barclays was accused of trading on material, non-public information that it received from participating on creditors

[39] However, the misappropriation theory of insider trading existed long before the *O'Hagan* decision in 1997. United States v. O'Hagan, 521 U.S. 642 (1997). Its origins may be traced back to the dissenting opinion in the *Chiarella* case. The majority in that case did not decide whether the theory had merit because it was not submitted to the jury. *Shapiro*, 495 F.2d at 236. Within a year after the *Chiarella* case, the Second Circuit adopted the misappropriation theory in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). Other circuit courts did not accept it. The *O'Hagan* decision resolved the conflict among the circuit courts. *O'Hagan*, 521 U.S. at 649.

[40] *O'Hagan*, 521 U.S. at 652.

[41] The lawyer was also held criminally liable for a violation of Rule 14e-3 and mail and wire fraud. *Id.*

[42] SEC v. Talbot, 530 F.3d 1085, 1093 (9th Cir. 2008).

committees relating to restructuring efforts of distressed companies.[43] The SEC claimed that this information was misappropriated from the companies, because Barclays had an obligation to them to keep the information confidential.[44] Barclays and one of its proprietary traders settled the case by paying $10.9 million and $750,000, respectively.

In logical terms, the misappropriation theory suffers from the weakness that the purported victim, the employer, will usually not have much, if any, interest in asserting insider trading claims against its employees. It is really certain shareholders of the employer, rather than the employer itself, who suffer the loss. Trading on inside information by corporate managers can be, and historically has been, regarded as an emolument of their service.[45] Moreover, the senior executives in charge of the corporation are unlikely to direct the corporation to sue themselves or their colleagues.

Logic, however, is not a strong attribute of the insider trading laws and has not impeded the application of the misappropriation theory by persons other than employers.[46] The standing of the SEC to sue on the basis of it has never been in serious doubt. Initial doubts about such standing of private plaintiffs were resolved by the adoption of Section

[43] SEC v. Barclays Bank PLC, No. 07 CV 4427 (S.D.N.Y. May 30, 2007). *See also* Mark J. Krudys, *Trading by Members of Creditors' Committees—Actionable!*, 44 DEPAUL L. REV. 99 (1994).

[44] Although the SEC utilized the misappropriation theory of insider trading in *Barclays*, it may also have been possible to rely on the classical theory of insider trading under the premise that a fiduciary duty exists between a company at or near insolvency and its debtholders. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939).

[45] *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 654 n.10 (1983) (the Supreme Court agreeing with the SEC that "[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office").

[46] *See, e.g.*, Bainbridge, *supra* note 7, at 1198 (a former SEC Commissioner acknowledges that the misappropriation theory can be seen as "merely a pretext for enforcing equal opportunity in information" (citing Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 366 (1988)).

20A of the Exchange Act.[47] In short, it provides that any person who trades while in possession of material, non-public information shall be liable to any person who, contemporaneously with such trading, has purchased or sold securities of the same class. However, in accordance with the *Blue Chip Stamps* decision, only purchasers or sellers of securities have standing.[48] Excluded are shareholders who have not traded, even though they may be harmed by insider trading violations.[49]

F. The Limits of the Classical and Misappropriation Theories of Insider Trading

1. The Loopholes in the Application of Insider Trading Theories to Equity and Equity-Linked Securities

In the large majority of imaginable cases directly concerning common or preferred stock, the classical, misappropriation, and tippee theories of insider trading, together with Rule 14e-3, forbid purchases or sales of such stock on the basis of material, inside information. However, in this regard a significant, not improbable, case falls outside their ambit. If an insider inadvertently communicates material, non-public information about an imminent merger to a stranger who trades on it, no violation under these

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[47] Securities Exchange Act of 1934, 15 U.S.C. § 78t-1(a) (2006) ("Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.").

[48] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[49] *See* William K. S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1235 (1981) (concluding that "[w]hen someone trades on nonpublic information, the group of all other investors suffers a net loss").

theories occurs because the insider has not breached a fiduciary duty and the stranger has not received the information as a result of such breach.[50] Rule 14e-3 does not apply to mergers, so the stranger's trading would only be punishable under it if the transaction at issue were a tender offer.

The various theories of insider trading also leave open strange loopholes with respect to equity-linked derivative securities, which persons may buy, sell, and hold without owning the underlying shares. Equity-linked derivatives may take the form of options, futures, forward contracts, equity swaps, and, broadly speaking, convertible bonds, exchangeable bonds, and certain complex, hybrid securities (often classified as structured notes). Issuers typically owe no fiduciary duty to the holders of derivative securities, assuming the holders are not, coincidentally, shareholders of the issuer. For this reason, the classical theory of insider trading is often unavailable in connection with equity-linked derivative securities. The courts have, for instance, held that the classical theory of insider trading does not apply to convertible debt securities because their issuers do not owe a fiduciary duty to holders.[51] The misappropriation theory of insider trading is inapplicable to holders of derivative securities, if, as may well be the case, they are not employed by a source of non-public information and are not otherwise bound by a confidentiality obligation to such source.

Trading in equity-linked derivative securities may be a good economic proxy or substitute for buying or selling the related shares. Thus, to close the loopholes relating to insider trading in certain types of equity-linked derivative securities, the U.S. Congress, at the SEC's prompting, added

[50] *See* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984). In this context, there is an assumption that the stranger is not a shareholder or employee of one of the merging companies, which facts might give rise to a fiduciary duty or a misappropriation claim, respectively.

[51] *See, e.g.*, Alexandra Global Master Fund, Ltd. v. Ikon Office Solutions, Inc., 2007 U.S. Dist. LEXIS 52546 (S.D.N.Y. July 20, 2007). *See infra* Part II.F.3.a.

Section 20(d) to the Exchange Act.[52] In essence, it provides that, if the insider trading laws would be violated by trading in the securities underlying a derivative security, then they are also violated by trading in the derivative security.[53] The main effect of this provision is to bring equity-linked derivative securities within the scope of the classical theory of insider trading. Regardless of Section 20(d), a derivative security, like any debt security, can be reached by the misappropriation theory of insider trading, the application of which theory is not confined to equity securities with associated fiduciary duties. If the securities or assets underlying a derivative are not in the form of equity and, therefore, not subject to the classical theory, then Section 20(d) does not add to the existing coverage of the misappropriation theory and does nothing to close the loopholes left open by it (which loopholes are analyzed below in Part II.F.3).

Furthermore, potential regulatory deficiencies and complexities relating to equity-linked derivative securities remain after the adoption of Section 20(d).[54] Its text only

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[52] Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered subdivisions of 15 U.S.C. § 78).

[53] Securities Exchange Act of 1934, 15 U.S.C. § 78t(d) (2006) (extending liability for trading in securities while in possession of material, non-public information: "Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provisions of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, privilege or security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act) with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.").

[54] Notably, in the case of CDOs, the underlying assets not only do not constitute equity securities, but may be loans that do not even qualify as securities. CDOs themselves, though, are debt-linked derivative securities and are as such directly covered by the misappropriation theory of insider trading. *See infra* Part II.F.3.

refers to puts, calls, straddles, options, privileges on any security,[55] and security-based swap agreements. Section 20(d) and the SEC's authority do not encompass all types of equity-linked derivative securities, although different forms of such derivative securities, such as forward contracts, futures or options, can accomplish similar economic results.[56] For instance, instead of the SEC, the Commodities Futures Trading Commission ("CFTC") is responsible for futures contracts, including options on futures contracts. Additionally, banking and other agencies regulate forward contracts, and many kinds of swaps.

Only three insider trading cases have addressed Section 20(d). It has not been applied to any securities other than options.[57] To reach equity-linked derivative securities that are not enumerated in Section 20(d), the idea might be developed that an option is embedded in them. However, the failure to specify them in a seemingly exhaustive list, and the absence of SEC authority over a number of different forms of them, argues against such extrapolation.[58] Another

[55] The text of Section 20(d) refers to "privileges," but this probably refers to "privileges on any security," the term used in the definition of security in Section 3(a)(10) of the Exchange Act.

[56] *See* Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1 (1996).

[57] Section 20(d) has been applied to insider trading in options in the following two cases: *Dau v. Cephalon, Inc.*, 2000 U.S. Dist. LEXIS 14534 (E.D. Pa. Sept. 25, 2000) and *Moskowitz v. Lopp*, 128 F.R.D. 624 (E.D. Pa. 1989). The only other insider trading case concerning Section 20(d) is *Clay v. Riverwood Int'l Corp.*, 157 F.3d 1259 (11th Cir. 1998), *vacated in part*, 176 F.3d 1381 (11th Cir. 1999), where the Eleventh Circuit held that Section 20(d) did not apply to certain stock appreciation rights relating to an employee benefit plan but affirmed that, as a result of Section 20(d), the insider trading laws are triggered by the purchase or sale of a put, call, straddle, or privilege.

[58] In *Alexandra Global Master Fund, Ltd. v. Ikon Office Solutions*, Inc., 2007 U.S. Dist. LEXIS 52546, at *17-22 (S.D.N.Y. July 20, 2007), the District Court for the Southern District of New York refused to separate out of a convertible debt security the equity characteristics embedded in it. It rejected the distinction from the *Green* case between (i) nondisclosure relating to the conversion option or other equity aspects of a convertible debt security, to which the classical theory of insider trading was applied

idea might be to extend Section 20(d) through its explicit reference to a privilege on any security. In *Clay v. Riverwood*, the Eleventh Circuit was, in passing, receptive to this idea, commenting that "Congress foresaw 'privileges' as new types of instruments that can be traded like options and stock."[59] However, futures, forward contracts, and other defined forms of derivative securities existing at the time of Section 20(d)'s enactment are difficult to characterize as privileges instead of the forms under which they are commonly known.

In comparison to the SEC, the CFTC and other regulators of derivative securities have not been active prosecutors of insider trading and do not have substantial, dedicated resources for this purpose.[60] Nevertheless, the SEC's

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and (ii) nondisclosure relating to its contractual, debtor creditor aspects, to which the classical theory of insider trading was considered inapplicable. *See* Green v. Hamilton Int'l Corp., No. 76 Civ. 5433, 1981 U.S. Dist. LEXIS 13439, at *14-17 (S.D.N.Y. July 14, 1981). The court did not address the possibility that Section 20(d) might cover the option embedded in a convertible debt security and trigger application of the classical theory of insider trading. While this possibility therefore remains open, the Court's unwillingness to separate the embedded option from the debt security as a whole is not favorable to application of the classical theory of insider trading.

[59] *See Clay*, 157 F.3d at 1267.

[60] Annette L. Nazareth, SEC Director of the Division of Market Regulation, recognized the SEC's disproportionate responsibility for regulating insider trading in testimony before the House Committee on Agriculture's Subcommittee on Risk Management, Research, and Specialty Crops: "In contrast to the broad prohibitions against insider trading found in the securities laws, the CFTC's regulations contain a narrow provision that prohibits only a small class of futures industry insiders from trading on non-public material information." *Reauthorization of the Commodity Futures Trading Commission: Hearing Before the Subcomm. on Risk Management, Research, and Specialty Crops of the H. Comm. on Agriculture*, 106th Cong. 65 (1999) (statement of Annette L. Nazareth, Dir. Div. Mkt. Regulation, SEC), *available at* http://www.sec.gov/news/testimony/testarchive/1999/tsty1399.txt.

Moreover, in the commodities context, companies that "wear multiple hats" sometimes legally use inside information to place bets with "an unusually detailed view of the industries it bets on . . . ." Ann Davis, *Cargill's Inside View Helps It Buck Downturn*, WALL ST. J., Jan. 14, 2009,

enforcement efforts may very well bring to light insider trading in derivative securities outside of the SEC's jurisdiction. If its effects are similar to insider trading in options, the SEC is unlikely to let it pass without prosecution (for example, by working with other regulators or the DOJ).[61] The extent to which other regulators, or regulation other than provisions under the Exchange Act, might cover insider trading in derivative securities is generally beyond the scope of this Article.

2. The *Dirks* Case and the Closing of Loopholes Resulting from it

a. The Reason For the Court's Limits on the Scope of the Insider Trading Laws

As we have seen, the courts ultimately made a patchwork series of concessions to the SEC that, despite a few, mostly temporary, setbacks, largely gave it a victory for its disclose or abstain precept. The insider trading laws have clearly been stretched and "spun" to cover "bad facts," rather than applied to the facts as a set of rules supplying a certain legal outcome. This observation, though, does not explain why the courts have not directly and explicitly identified, and then expressed in cogent legal terms, the real reasons for regarding facts as objectionable or not.

The fundamental question remains why the case law technically restricts the definition of insider trading as a formalistic matter, refusing to fully accept SEC policy and leaving loopholes in the SEC's disclose or abstain precept. In seeking a response to this question, we will focus on one of the largest of these loopholes, which concerns the dissemination of inside information given to research

at A1. For example, Greg Page, Cargill Inc.'s chief executive, has acknowledged that Cargill "does a good job of assimilating all those seemingly unrelated facts." *Id.*

[61] The *O'Hagan* Court indicated that, where the SEC cannot bring securities fraud charges, the DOJ may be able to bring charges of mail and wire fraud. United States v. O'Hagan, 521 U.S. 642, 677-78, 700-01 (1997).

analysts, and which remained open for approximately twenty years until addressed by SEC rule making.

Before examining this topic, we should note that one explanation for the overly complex case law lies in the courts' respect for the principle that criminal laws should be strictly construed.[62] Mindful of this principle, the courts are generally reluctant to overly extend the insider trading laws.[63] They recognize that what is material or non-public is not always self-evident.

Nevertheless, another, more significant, explanation for the limitations of the insider trading case law can be discovered in the *Dirks* case, which raises in its facts and discussion the social policy issues at the core of insider trading law. In this case, an officer of a broker-dealer firm,

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[62] Going further, fervent believers in strict constructionism might take the Court's insider trading decisions at face value as necessarily compelled by the language and original intent of Section 10(b) of the Exchange Act. *See supra* note 24. However, this potential explanation of the insider trading case law is difficult to reconcile with its history of inconsistency over time and qualifications to basic principles, which strongly suggests that the statute's meaning is by no means self-evident. Moreover, the Supreme Court's decisions in *O'Hagan*, *Dirks*, and *Santa Fe Industries*, the sources of the Court's limited reading of Section 10(b) and inspiration for *Chiarella's* fiduciary duty requirement, are justified not just by reference to language and legislative history, but to policy concerns as well. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474-80 (1977). In the case of *Santa Fe*, these concerns were the dangers of vexatious litigation and federal intrusion on state jurisdiction. See *infra* for a discussion of the policy concerns animating *Dirks* and *O'Hagan*.

[63] *O'Hagan* rejects the defendant's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability because the theory is limited to those who breach a recognized duty and criminal liability under the theory requires the presence of culpable intent as a necessary element of the offense. *O'Hagan*, 521 U.S. at 666. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 33-7787, Exchange Act Release No. 34-42259, 64 Fed. Reg. 72,590, 72,602-03 (proposed Dec. 28, 1999) (referring to the *Chestman* case described at Part II.F.2.b, *infra*, the SEC observes that "*Chestman* makes clear that its narrow approach, in contrast to the 'elastic' definition of confidential relations employed by courts of equity in the civil context, was influenced by the criminal context of the case before it" (quoting United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (en banc)).

Dirks, received from corporate insiders of an insurance company information that the insurance company's assets were vastly overstated as a result of fraudulent corporate practices.[64] Dirks revealed the information to clients of his firm.[65] Dirks also communicated this information to the Wall Street Journal.[66] However, the Journal did not publish a story until after word of the fraud allegations had spread and the share price of the insurance company had dropped significantly.[67]

An SEC administrative law judge censured the defendant, concluding that "[w]here 'tippees—regardless of their motivation or occupation—come into possession of material information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."[68] The Supreme Court overruled the SEC, finding that Dirks was not a temporary insider, a tippee that had assumed an insider's duty to the shareholders, or any other type of person that had a fiduciary duty to the insurance company's shareholders.[69] Because the insiders did not violate their fiduciary duty to shareholders by providing him with information, no derivative fiduciary duty on the part of the defendant arose.[70] Receiving no monetary or personal benefit for it, they were only motivated by a desire to expose fraud.[71]

The Court rejected the SEC's idea that the antifraud provisions of the securities laws require equal information among all traders. It characterized the idea as "a radical view of securities trading" for which the SEC had presented no explicit evidence of Congress's intention to adopt.[72] The

[64] Dirks v. SEC, 463 U.S. 646, 648-49 (1983).

[65] *Id.* at 649.

[66] *Id.* at 649-50.

[67] *Id.*

[68] *Id.* at 651 (citation omitted).

[69] *Id.* at 665.

[70] *Id.* at 667.

[71] *Id.*

[72] *Id.* at 657 n.16.

Court's theories of insider trading are thus an attempt to draw a line, short of this "radical view," between normal trading on the basis of perceived or actual informational advantage and illegitimate insider trading. The Court observed that "it is commonplace for analysts to 'ferret out and analyze information'"[73] and that information obtained by the analysts "normally may be the basis for judgments as to the market worth of a corporation's securities."[74] The Court opined that the SEC's unqualified disclose or abstain rule "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[75]

The Court's concerns regarding the disclose or abstain rule and decision in *Dirks* are less persuasive today than at the time, because of what has been learned from the research analyst scandal after the collapse of the Internet bubble[76] and the downfall of Bear Stearns, possibly attributable to short-selling activity and related rumor mongering.[77] Indeed, even at the time, the dissent in *Dirks* was suspicious because it regarded Dirks' attempt to provide information to nonclients as "feeble, at best."[78] On the same day that he provided a full report of the fraud allegations to one of his clients, Dirks left a message for the Wall Street Journal. He never reported the insurance company to the SEC and did not follow up with the Journal until after this client had sold its shares and other clients had been informed. Dirks' contact with the Wall Street Journal

[73] *Id.* at 658.

[74] *Id.* at 659.

[75] *Id.* at 658.

[76] *See, e.g.*, Regulation Analyst Certification, Securities Act Release No. 33-8193, Exchange Act Release No. 34-47384, 68 Fed. Reg. 9482 (Feb. 27, 2003); *SEC Adopts Regulation AC*, SEC TODAY (Feb. 7, 2003); *Merrill Lynch Settles NY Charges of Analyst Conflicts, To Pay US$100M*, WORLD SECURITIES LAW REPORT 3-4 (June 2002); *SEC Launches Formal Inquiry into Possible Analyst Conflicts*, WORLD SEC. L. REP. 6-7 (May 2002).

[77] Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR (Aug. 2008), *available at* http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808 (last visited Apr. 26, 2009).

[78] *Dirks*, 463 U.S. at 670 (Blackmun, J., dissenting).

seemed calculated to allow him to claim that he sought disclosure, while still enabling his clients to shift their inevitable losses to uninformed market participants.

Nonetheless, the view of the *Dirks* Court may resonate with traders at hedge funds, who make their living by being better informed than the financial markets and whose Darwinian experience with the markets belies any fictional construct of equal information among traders. Compliance personnel at hedge funds should therefore be able to explain to traders why the view of the *Dirks* Court has not been accepted by the SEC or the more recent *O'Hagan* decision of the Supreme Court. The reason resides in the distinction between superior awareness and understanding of available information, and privileged, unequal access to inside information. While rewarding the former is fair and economically efficient, permitting the latter is not. Accordingly, the *O'Hagan* Court explained:

> Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research skill.[79]

b. The Aftermath of the *Dirks* Case: Regulation FD, Rule 10b5-1, and Rule 10b5-2

Treating *Dirks* as wrongly decided, the SEC initially sought to limit its effect by punishing a corporate insider for selectively disclosing non-public information to research analysts.[80] The SEC did not follow this approach in *Dirks* because the key corporate insider did pass on his information to regulatory authorities as well as *Dirks*. Subsequently, in

[79] United States v. O'Hagan, 521 U.S. 642, 658-59 (1997).

[80] SEC v. Stevens, Litig. Release No. 12813 (Mar. 19, 1991).

2000, the SEC effectively annulled *Dirks* by adopting Regulation FD. In brief, this regulation imposes on issuers an obligation to make public material non-public information if the issuer, or any person acting on its behalf, reveals such information to hedge funds or certain other enumerated securities market professionals and does not obtain their agreement to maintain such information in confidence.[81]

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[81] Hedge funds will almost always fall under the definition of investment adviser in Section 202(a)(11) of the Investment Advisers Act, even though they may qualify for an exemption from registration as an investment adviser. *See infra* Part III.A; *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004). The other persons covered by Regulation FD's restrictions on selective disclosure are specified in its key operative provision, Rule 100(a). This provision states that:

> a. Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in Rule 101(e):
>
> 1. Simultaneously, in the case of an intentional disclosure; and
> 2. Promptly, in the case of a non-intentional disclosure.
>
> b.
>
> 1. Except as provided in paragraph (b)(2) of this section, paragraph (a) of this section shall apply to a disclosure made to any person outside the issuer:
>
> i. Who is a broker or dealer, or a person associated with a broker or dealer, as those terms are defined in Section 3(a) of the Securities Exchange Act of 1934;
> ii. Who is an investment adviser, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940; an institutional investment manager, as that term is defined in Section 13(f)(5) of the Securities Exchange Act of 1934, that filed a report on Form 13F with the Commission for the most recent quarter ended prior to the date of the disclosure; or a person associated with either of the foregoing. . . .;

If a securities analyst has a duty to maintain confidentiality and then trades on the basis of material, non-public information about the issuer or, in return for a direct or indirect personal benefit, tips another person who so trades, he is in violation of Exchange Act Rule 10b-5 and federal securities laws under the misappropriation theory of insider trading. A tippee who trades on such information would also be in violation of the insider trading laws if the tippee knew or should have known it was confidential.

Thus, Regulation FD addresses the issue that a tippee may, under *Dirks*, be free to trade on inside information if the tipper had a legitimate purpose in providing the tippee with such inside information and, therefore, did not violate a duty of confidence in divulging such inside information. Regulation FD overcomes this problem under *Dirks* by compelling issuers to impose a duty of confidence, or publicly disclose, when releasing material, inside information.

Further reinforcing the extension of the confidentiality duties on which the insider trading laws repose, the SEC adopted Rule 10b5-2 at the same time as Regulation FD. This rule was intended to reverse the holding in *United States v. Chestman* that a family relationship alone, such as a marriage, does not suffice to create a duty of trust or

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> iii. Who is an investment company, as defined in Section 3 of the Investment Company Act of 1940, or who would be an investment company but for Section 3(c)(1) or Section 3(c)(7) thereof, or an affiliated person of either of the foregoing. . . .; or
> iv. Who is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.
>
> 2. Paragraph (a) of this section shall not apply to a disclosure made:
>
> i. To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant); [or]
> ii. To a person who expressly agrees to maintain the disclosed information in confidence; . . . .

17 C.F.R. § 243.100(a) (2008).

confidence.[82] The rule provides that such a duty exists: (i) among a person and his or her spouse, parent, child or sibling, subject to a certain exception,[83] (ii) whenever a confidentiality agreement exists and (iii) whenever there is a history, pattern, or practice of sharing confidences.

Concurrently, the SEC also promulgated Rule 10b5-1, which resolved a split among the circuit courts by clarifying that a person may be liable for insider trading while knowingly in possession of material, non-public information.[84] The Ninth Circuit's *Smith* decision had required that use of such information be proven in a criminal case.[85]

Noting that many recent cases of selective disclosure had been reported in the media, the SEC justified its adoption of Regulation FD on the grounds that "selective disclosure poses a serious threat to investor confidence in the fairness and integrity of the securities markets."[86] In response to criticism that Regulation FD might have a chilling effect on communication to analysts or discourage the work of research analysis, the SEC propounded the mosaic theory.[87] Issuers were encouraged under this theory:

> to divulge tidbits of non-material information to analysts to help them piece together more informed

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[82] United States v. Chestman, 947 F.2d 551 (2d Cir. 1991); Selective Disclosure and Insider Trading, Securities Act Release No. 33-7887, Exchange Act Release No. 34-42259, 64 Fed. Reg. 72,590, 72,602-603 (Dec. 28, 1999).

[83] 17 C.F.R. § 240.10b5-2 (2008) (explaining that to be exempt, the person obtaining the information must show that no duty of trust or confidence existed with respect to the information by establishing that he neither knew, nor reasonably should have known, that the source of the information expected it to remain confidential based upon the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information).

[84] Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,600-02.

[85] United States v. Smith, 155 F.3d 1051 (9th Cir. 1998).

[86] Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

[87] *Id.* at 72,593 n.26 (citing SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977)).

> opinions . . . . [A]lthough giving analysts direct, nonpublic material information was prohibited, the law should permit "[a] skilled analyst with knowledge of [a] company and the industry [to] piece seemingly inconsequential data together with public information into a mosaic which reveals material, non-public information."[88]

The mosaic theory, together with the *Dirks* case, gives rise to the potential for a loophole in the insider trading laws. A respected sell-side analyst, able to move markets with his opinions about an issuer, may insightfully develop a view on it without having had privileged, confidential access to it or material inside information. If the analyst divulges to select persons his upcoming recommendation about the issuer's securities and these persons trade in them, neither he nor they will have breached a fiduciary duty to the issuer in violation of the classical theory of insider trading. His divulgation may not constitute misappropriation from his employer, because it may be regarded as consistent with the employer's interest in the analyst's job of currying favor with the employer's clients. Indeed, selective disclosure of analyst reports is the norm, since their distribution is usually targeted towards certain institutional investors.

Nonetheless, the SEC or DOJ might very well seek to prosecute such analysts or traders, as the *Carpenter* case attests.[89] *Carpenter* concerned a journalist who engaged in a scheme of providing two brokers with advance information about the timing and contents of his Wall Street Journal column, which could have affected securities prices. Even though this information was not corporate inside information, the journalist and the brokers were convicted of mail and wire fraud on the grounds that the journalist misappropriated information by depriving his employer of its exclusive use. As suggested by the prosecutions and regulations relating to the analyst scandal after the collapse of the Internet bubble, the SEC, DOJ and even state

[88] *Id.*

[89] Carpenter v. United States, 484 U.S. 19 (1987).

attorneys general, under statutes such as New York's Martin Act,[90] could become aroused to press charges, and find creative legal theories, to punish an analyst or some other individual whose conduct is similar to the *Carpenter* fact pattern, but not within the misappropriation theory.

3. The Loopholes in the Application of Insider Trading Theories to Debt and Debt-Linked Securities

Approximately a decade and a half ago, Harvey Pitt, who later became Chairman of the SEC, and Karl Groskaufmanis published an article arguing that the treatment of options, on the one hand, and high-yield and convertible bonds, on the other hand, was incongruous under the insider trading laws.[91] The value of an issuer's equity may be reflected in the price of all of these different types of securities, but only trading in options is subject to the classical theory of insider trading (as a result of Section 20(d) of the Exchange Act).[92] The article implied that a test case or regulation could be expected to close the loopholes relating to this theory's inapplicability to debt securities.

a. The Loophole Relating to Issuer Self-Trading of Debt Securities

Pitt and Groskaufmanis observe that one of these loopholes is trading by an issuer in its own debt securities. This observation is now supported by the holding in a recent case, *Alexandra Global Master Fund, Ltd. v. Ikon Office*

[90] N.Y. GEN. BUS. LAW § 352-C (McKinney 2008). Eric Dinallo, former Bureau Chief of the New York State Attorney General's Office Investor Protection and Securities Bureau and currently Superintendent of the New York State Insurance Department, has called the Martin Act "one of the broadest anti-fraud statutes ever devised, at least in a democratic society." Eric Dinallo, *Prosecuting Securities Fraud From A New York Perspective*, 5 N.Y.U. J. LEGIS. & PUB. POL'Y 41 (2001-2002).

[91] Pitt & Groskaufmanis, *supra* note 7.

[92] *See supra* Part II.F.1.

Solutions, Inc. [93] In this case, an issuer of convertible debt securities repurchased them at 99.75% of their face value without informing the seller that it was planning to raise money in a private placement to redeem the bonds at 102% of their face value. Emphasizing that "the indenture under which bonds are issued circumscribes the rights owed to noteholders,"[94] the U.S. District Court for the Southern District of New York held that the issuer did not have a fiduciary duty to its bondholders and, therefore, did not violate the insider trading laws by its nondisclosure. Contrary to the suggestion in the Pitt article that the classical theory of insider trading might be extended to convertible debt securities, the court rejected arguments that "convertible debentures holders possessed a sufficient equity interest in the issuing corporation to justify the imposition of fiduciary duties."[95] It noted that the misappropriation theory was not applicable to the facts of the case (presumably with the implicit understanding that this theory will never reach an issuer's trading in its own securities).[96]

b. The Loophole Relating to Debt Private Placements

The debt hypotheticals described at the beginning of this Article constitute another of the loopholes in the insider trading theories, for the following reasons. An issuer and its representatives may, for legitimate marketing purposes, reveal to certain persons the issuer's potential plans to offer debt securities in a Rule 144A private placement. The issuer's representatives may themselves be obligated to treat this information as confidential and material and abstain from trading, but their revelation of it for these marketing

[93] Alexandra Global Master Fund, Ltd. v. Ikon Office Solutions, Inc., No. 06 Civ. 5383, 2007 U.S. Dist. LEXIS 52546 (S.D.N.Y. July 20, 2007).

[94] *Id.* at *32.

[95] *Id.* at *16-17. Note that the court cited the Pitt article, so it was fully aware of the arguments in favor of applying the classical theory of insider trading to convertible debt securities. *Id.* at *15.

[96] *Id.* at *31 n.11.

purposes will not constitute a breach of a duty of confidence.[97] The issuer may choose not to give public notices of its private placement plans pursuant to Rule 135c under the Securities Act of 1933 (the "Securities Act"), for example, because the plans are not certain or the notice poses the risk of conditioning the market. Regulation FD does not apply to a foreign private issuer and, in any event, allows a domestic issuer to selectively disclose the private placement plans to its placement agents. Consistent with common market practice, the placement agents will usually seek confidentiality agreements from potential investors, but are not bound by Regulation FD and are not required to do so. They may make exceptions for potential investors that are good prospects, but unwilling to enter into confidentiality agreements.

The insider trading laws do not reach trading by such investors because they (i) did not, as tippees, receive information improperly from a tipper's breach of a duty of confidence, (ii) did not misappropriate it in breach of a confidentiality obligation to its source, and (iii) did not have a fiduciary duty to the issuer (assuming they are not its shareholders). For the same reasons, if information about the private placement inadvertently leaks out of the placement agents, or out of investors that have entered into confidentiality agreements, none of the placement agents, such investors or the beneficiaries of the leak fall within the scope of the insider trading laws.

Even if the private placement involves equity, instead of debt securities, there are doubts about the applicability of the insider trading laws to hypotheticals that are similar to those discussed above. For example, a significant shareholder may learn in advance of the public about a PIPE transaction, but may not qualify as a controlling shareholder with a fiduciary duty to other shareholders or as a person with duty of confidence to the issuer or its representatives.[98]

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[97] *See supra* Part III.F.1.

[98] This fact pattern is highlighted by the recent case concerning insider trading allegations against Mark Cuban, the owner of the Dallas Mavericks basketball team. Kara Scannell, Leslie Eaton & Stephanie

The reach of the U.S. insider trading laws could also be uncertain when the issuer is incorporated in a non-U.S. jurisdiction that does not have a common law of fiduciary duty and misappropriation like in the United States (e.g., the common law concept of a fiduciary duty being foreign to many civil law jurisdictions).

c. The Loophole Relating to CDSs

Yet another loophole in the coverage of the insider trading laws concerns non-securities based swap agreements, in particular credit default swaps ("CDSs"), a form of debt-linked derivative. Until September 2008, this esoteric instrument was only known to sophisticated lawyers, regulators, and financiers. It has exploded into public prominence as a result of the U.S. government's nationalization of American International Group, Inc. ("AIG"), which was required because AIG's default on its CDS obligations would have wreaked havoc on the world's financial system. The $58 trillion notional size of the CDS market suggests the enormity of the current concern with

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Simon, *SEC Calls a Foul on NBA's Cuban, Alleges Insider Trades in Web Firm*, WALL ST. J., Nov. 18, 2008 at A1, *available at* http://online.wsj.com/article/SB122693827604333637.html. Cuban asserts, contrary to the SEC complaint, that he never agreed to keep confidential information about an upcoming, dilutive PIPE which he learned about from the CEO of the issuer and on which he traded before public announcement of the PIPE. Kara Scannell & Leslie Eaton, *Cuban Lays Out Defense To Insider-Trade Charges*, WALL ST. J., Nov. 19, 2008 at C3, *available at* http://online.wsj.com/article/SB122705402440639311.html; Complaint, SEC v. Cuban (N.D. Tex. Nov. 17, 2008), *available at* http://online.wsj.com/public/resources/documents/cubancom plaint.pdf. Under Cuban's version of the facts, the SEC might still have some argument that, even if Cuban did not have a fiduciary duty to other shareholders, he had a duty of trust or confidence (i) under Rule 10b5-2(b)(2) because he and the issuer had a history, pattern or practice of sharing confidences or (ii) under *Dirks* and its progeny because of a special relationship with the issuer. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983); 17 C.F.R. § 240.10b5-2(b)(2). *See also* Anabtawi & Stout, *supra* note 25 (arguing for an expansion of fiduciary duties among shareholders).

CDSs.[99] The potential for insider trading in them is rife in the current credit crunch environment. "Hedge funds, mutual funds and other investors increasingly have turned to the contracts to make bets on credit quality because they are cheaper and easier to trade than the securities on which they are based."[100] Indeed, trading in CDSs may be a substitute for shorting stock in certain circumstances, as well as for debt trading.[101]

CDSs are largely unregulated. SEC Chairman Christopher Cox has referred to the CDS market as a "regulatory hole" because "neither the SEC nor any regulator has authority over the CDS market."[102] In the late 1990s, the Commodities Futures Trading Commission ("CFTC") attempted to regulate CDSs, but, in 2000, Congress passed the Commodity Futures Modernization Act, which made clear that these instruments were to remain unregulated.[103]

The SEC lacks the authority to directly regulate these instruments because they fall outside the definition of a

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[99] *Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the Subcomm. on Banking, Housing and Urban Affairs* 109th Cong. (2008) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2008/ts092308cc.htm [hereinafter *Cox Testimony Concerning Turmoil in U.S. Credit Markets*]. *But see*, Message from Chairman Cox, 2008 Performance and Accountability Report, SEC, at 4, *available at* http://www.sec.gov/about/secpar/secpar 2008.pdf [hereinafter SEC Annual Report for 2008] (citing $55 trillion market in credit default swaps).

[100] Shannon D. Harrington & Craig Torres, *Federal Reserve Chief Says Existing Laws Cover Abuses in Credit-Default Swaps*, INT'L HERALD TRIB., May 16, 2007, at 16; James Surowiecki, *Everyone's Watching*, NEW YORKER, Nov. 10, 2008, at 35, *available at* http://www.newyorker.com/talk/financial/2008/11/10/081110ta_talk_surowiecki.

[101] *See, e.g.*, Surowiecki, *supra* note 100.

[102] *Cox Testimony Concerning Turmoil in U.S. Credit Markets*, *supra* note 99; SEC Annul Report for 2008, *supra* note 99, at 4 ("Congress needs to pass legislation that would not only make credit default swaps more transparent, but also give regulators the power to rein in fraudulent or manipulative trading practices.").

[103] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

"security" under both the Securities Act and the Exchange Act.[104] However, the Enforcement Division of the SEC has used its antifraud authority, "even though swaps are not defined as securities, because of concerns that CDSs offer outsized incentives to market participants to see an issuer referenced in a CDS default or experience another credit event."[105] This antifraud authority is in Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, which apply to "any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act)."[106]

The SEC's antifraud authority, including its ability to prohibit insider trading, is limited to securities-based CDSs. If the swap agreement is "non-securities based," Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act do not apply. Section 206B of the Gramm-Leach-Bliley Act defines "security-based swap agreement" as a "swap agreement . . . of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein."[107] Section 206C defines non-security-based swap agreement as "any swap agreement . . . that is not a security-based swap agreement."[108] Thus, the SEC has jurisdiction over insider trading of CDSs linked to debt securities. Although widely prevalent, CDSs linked to loans are outside of this jurisdiction.

Insider trading in non-security based swap agreements could be prosecuted by the DOJ under the federal mail and wire fraud statutes.[109] In *Carpenter v. United States*, the

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[104] Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2006).

[105] *See Cox Testimony Concerning Turmoil in U.S. Credit Markets*, *supra* note 99.

[106] Securities Act of 1933, 15 U.S.C. § 77q(a) (2006); Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006).

[107] Gramm-Leach-Bliley Act, 15 U.S.C. § 78c-1 (2006).

[108] *Id.*

[109] 18 U.S.C. §§ 1341, 1343 (2006). The wire statute provides:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by

Supreme Court held that misappropriation was a crime under these statutes as well as Rule 10b-5.[110] The scope of the mail and wire fraud statutes is potentially broader, because they are not restricted by the language "in connection with the purchase or sale of a security" that is a condition for a Rule 10b-5 claim. These statutes have not, but could, be used to partially close the loopholes relating to the inapplicability of Rule 10b-5 to financial instruments that do not qualify as securities, such as non-security-based CDSs, interest rate swaps and currency swaps.[111]

However, since the mail and wire fraud statutes require a misappropriation theory, they, like the insider trading laws under Rule 10b-5, are limited by the constraints of this theory that have been described above. An open question

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> means of false or fraudulent premises, representations or promises, transmits or causes to be transmitted by means of wire, radio or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C. § 1343. The text of § 1341 is similar, except that it applies to the mails and to mailings for such a scheme or artifice "to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article . . . ." This additional quoted language is not found in the wire statute.

[110] Carpenter v. United States, 484 U.S. 19 (1987). The same conclusion is reached in *O'Hagan*, which highlights that charges of mail and wire fraud may be brought by the DOJ, but not the SEC. United States v. O'Hagan, 521 U.S. 642, 642 (1997).

[111] For example, the Securities Industry and Financial Markets Association ("SIFMA") has filed an amicus brief in *SEC v. Langford* asserting that "swap agreements under which payments are based on the SIFMA Swap Index . . . are not 'security-based swap agreements.'" Brief for Securities Industry and Financial Markets Association as Amicus Curiae Supporting Plaintiff, SEC v. Langford, CV-08-0761-S (N.D. Ala. filed Apr. 30, 2008).

exists as to whether a New York State prosecutor could use New York's Martin Act to avoid these constraints.[112]

d. The Openness or Not of the Loopholes

In the special pre-bankruptcy context where loopholes in the misappropriation theory are hard to imagine, the insider trading laws have been extended to debt securities in the recent *Barclays* case.[113] Surprisingly, at least on first impression, no other case of any prominence has been forthcoming in this area of debt or debt-linked derivative securities, even though the SEC must have some awareness of the loopholes. Thus, the question arises whether the SEC is like the famous dog that did not bark in the Sherlock Holmes novel "The Hound of the Baskervilles;" that is, whether the SEC's quiescence suggests a conclusion about the extent to which the insider trading laws will not be applied to debt securities and debt-linked derivative securities.

Indeed, this question poses the broader question why the insider trading laws have not been clarified and rationalized by legislation. Part of the answer is that the U.S. securities laws need, in general, such reform, but the U.S. political and legal systems appear to be incapable or unwilling of it, or both. For instance, the large majority of scholars and practitioners now agree that the passage of the Exchange Act a year after the Securities Act was an accident of history, the two old acts normally should have been combined and updated in a more recent statute and this combination has been effectively achieved through complicated SEC rule making and interpretation over time. One of the instruments of such combination, the Securities Offering or Aircraft Carrier Lite Reform, was only adopted after an earlier, more comprehensive reform, known as the Aircraft Carrier, failed. The SEC's elaboration of it took 468 pages even though it was intended to be considerably less extensive than the

[112] N.Y. GEN. BUS. LAW § 352-C (McKinney 2008).

[113] SEC v. Barclays Bank PLC, No. 07 CV 4427 (S.D.N.Y. May 30, 2007).

antecedent Aircraft Carrier proposal.[114] This experience illustrates the comparative incapacity for elegant codification within the U.S. system and its common law tradition. It was also a sharp reminder to the SEC and others of the difficulties in revising the U.S. securities laws. The typical reaction to comprehensive or systemic overhaul of the U.S. securities laws is a skeptical "if it ain't broke, don't fix it."

More specifically with regard to insider trading, the SEC did, in 1987, seek legislation codifying the misappropriation theory.[115] This legislation was never enacted, because it was regarded both as too complex and too ambiguous in some of its provisions.[116] Although these problems could have been avoided by a statute based on the SEC's precept of disclose or refrain from trading, the SEC may have felt at the time that proposal of such a statute was at risk of being rejected as overreaching. The SEC likely came to realize that such rejection could be a significant policy defeat, while Congressional ratification of the misappropriation theory could still leave loopholes and possibly have the unintended consequence of limiting the SEC's flexibility to promote adherence to its disclose or abstain precept. The SEC, as well as Congress, seem to have concluded that the definition of insider trading is better developed through the common law approach of case-by-case decisions rather than through codification.[117]

Accordingly, the absence of general insider trading legislation is not astonishing, but rather consistent with the overall messiness of U.S. securities regulation, predilections for the common law approach, and SEC regulatory strategy. Specifically, with respect to insider trading in debt securities, the SEC has not been active in bringing test cases

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[114] Securities Offering Reform, Securities Act Release No. 33-8591, Exchange Act Release No. 34-52056, 70 Fed. Reg. 44722 (Aug. 3, 2005).

[115] *See* JESSE H. CHOPER, JOHN C. COFFEE & C. ROBERT MORRIS, CASES AND MATERIALS ON CORPORATIONS 485-86 (3d ed. 1989).

[116] *Id.*

[117] *Id.*; *see also* Preliminary Note to Rule 10b5-1 and Preliminary Note to Rule 10b5-2, 17 C.F.R. § 240.10b5-1 and 10b5-2 (2008) ("The law of insider trading is otherwise defined by judicial opinions.").

or initiating additional regulation outside of the pre-bankruptcy context, but this fact should not lead to the conclusion that the SEC regards it as legally justifiable or acceptable. Rather, the SEC likely believes that the misappropriation theory, Regulation FD,[118] and other existing law on insider trading are largely adequate to combat it. The dearth of prominent enforcement actions is probably attributable in part to the sophistication of the institutions that trade in the private markets for debt securities. Not only are they less likely to be victims of insider trading, they are less in need of SEC protection from it and are considered a relatively low priority for such protection as compared to unsophisticated individual investors who trade in the public markets for equity securities.

In addition, the value of debt securities often has limited sensitivity to disclosure issues, in particular when their place in the capital structure is taken to mean their repayment is assured. The pre-bankruptcy setting is exactly one of the exceptional situations in which debt securities may have this sensitivity and in this way resemble equity securities. The *Barclays* case signifies that the SEC will at least pursue insider trading in this one situation. This situation is not, however, the only one in which these circumstances arise. High yield and convertible bonds, for example, may trade very much like equity.

Given the SEC's long attachment to the principle of disclose material, inside information or refrain from trading, and history of expanding the insider trading laws in accordance with it, the *Barclays* case likely indicates that the SEC is interested in prosecuting trading of debt securities on the basis of material, inside information whenever their price may be artificially affected by non-disclosure of this information. In fact, a sign of increased enforcement in this area may be the recent SEC and DOJ charges against two

[118] *See* Michael A. Harrison, *Regulation FD's Effect on Fixed-Income Investors: Is the Public Protected or Harmed?*, 77 IND. L.J. 189 (2002) (arguing that Regulation FD clearly does, but should not, apply to selective disclosure to holders of debt securities).

former Bear Sterns hedge fund managers relating to insider trading in CDOs.[119] Another indication may be the recent settlement between David Aufhauser, former general counsel for UBS AG's investment bank, and the New York Attorney General's Office for alleged insider trading in the auction-rate securities market in violation of New York's Martin Act.[120] Especially in light of the credit crunch, controversy over CDOs and other complex debt securities, and concerns about the role of hedge funds in the markets, such trading could attract attention as a threat to public confidence in the markets and, as such, motivate enforcement efforts.

For the same reasons, trading in CDSs and other debt-linked derivatives is susceptible to insider trading enforcement actions by the SEC and DOJ. In this vein, SEC Chairman Christopher Cox has recently urged Congress to grant the SEC regulatory oversight of the CDS market.[121]

G. Social Considerations Relating to Compliance with the Insider Trading Laws

Hedge fund traders must, in regards to equity securities, respect the SEC's distinction between unfair, deleterious insider trading and legitimate, beneficial trading on informational advantage under the mosaic theory or the basis of publicly observable developments. However, they could conceivably get industry groups of financial institutions and institutional investors to proclaim that the insider trading laws do not apply to debt securities. Caveat emptor (buyer beware) is the default rule in many non-

[119] United States v. Cioffi, No. 08-415 (E.D.N.Y. June 18, 2008); *see also* Press Release, DOJ, *supra* note 4.

[120] *See* Liz Rappaport, *Auction-Rate Case Settled By Former UBS Lawyer*, WALL ST. J., Oct. 8, 2008, at C1, *available at* http://s.wsj.net/article/SB122339911083811849.html; *In re* Investigation by Andrew M. Cuomo, Attorney General of the State of New York, of David Aufhauser, Assurance No. 08-135 (Oct. 7, 2008), *available at* http://www.oag.state.ny.us/media_center/2008/oct/Aufhauser%20AOD%20(Markowitz,Aufhauser,%20Warin%20signatures).pdf.

[121] *See Cox Testimony Concerning Turmoil in U.S. Credit Markets*, *supra* note 99; SEC Annual Report for 2008, *supra* note 99.

consumer markets. It would not be unprecedented or intrinsically unfair for the sophisticated players in the debt markets to do without the protection of these laws if they knew about its absence in advance. Nevertheless, we believe, with considerable support from the academic literature, that this approach would not be appropriate for the financial markets or hedge funds in general. Thus, we recommend that compliance personnel at hedge funds promote their traders' observance of the insider trading laws in the fixed income area by emphasizing that it is in their interest. Indeed, to ensure a level playing field, eliminate any doubts, and improve public relations, hedge funds might encourage and enhance compliance with the insider trading laws in the debt (and other) markets by devising, at the industry level, model guidelines for this purpose.

Thus, in understanding the importance of compliance programs, hedge funds should be cognizant of the widely accepted view that the insider trading laws serve the economic policy objective of investor confidence in the integrity of the financial markets. Furthermore, hedge funds should be sensitive to the social context in which insider trading cases may arise. They can be high-profile, show trials that stir the popular imagination, inspire Oliver Stone and James Bond films (Wall Street[122] and Casino Royale[123]) and resemble the situation in Bonfire of the Vanities.[124] Insider trading issues were the cause of the demise of the investment bank Drexel Burnham Lambert.[125] They also prompted an incredible outpouring of public comment on the SEC's Regulation FD.[126]

Prosecutors can achieve prominence, even make a political career, from cases of insider trading and the like.

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[122] WALL STREET (Twentieth Century Fox Film Corp. 1987).

[123] CASINO ROYALE (EON Productions 2006).

[124] TOM WOLFE, THE BONFIRE OF THE VANITIES (1987).

[125] *See, e.g.*, Pitt & Groskaufmanis, *supra* note 7, at 216-17.

[126] The SEC received nearly 6000 comment letters on the proposing release for Regulation FD. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,716, 51,717 (Aug. 15, 2000).

Indeed, in this way, Elliot Spitzer became governor of New York. Likewise, as U.S. Attorney for the Southern District of New York, former New York City Mayor Rudolph Giuliani prosecuted Michael Milken and Ivan Boesky in high-profile insider trading cases. While the bread and butter work of the criminal justice system is putting poor defendants in prison, often without a trial, insider trading cases appeal to prosecutors' and America's self-image, because they help show that justice is blind and applied equally to the wealthy and poor. For those with moralistic tendencies, tinged perhaps with jealousy toward those who make more money, insider traders are especially deserving of condemnation, because they do not have the excuse of impoverished circumstances. This impulse to punish may be exacerbated by a populist dislike for greedy, corrupt Wall Street, recently evidenced by statements of the presidential candidate John McCain.[127]

Moreover, as Professor Ronald Gilson proposes, Americans equate fairness with equal access, the principle underlying the insider trading laws. Americans tend to favor markets for regulating economic activity, because they reward "what you do, not whom you know."[128] Thus, he argues that the breadth of political support for the market, and the insider trading laws, "rests on perceptions of fairness, not efficiency."[129] For these and whatever other reasons—malicious interest in the downfall of the mighty or the crowd psychology behind the popularity of public hangings or the guillotine—insider trading cases often are the stuff of scandals in the tabloid press.

The Martha Stewart case illustrates not only the appeal of an insider trading scandal to the media, but also the lengths to which the government will go to prosecute insider

[127] David Jackson, *McCain, Obama Eye Wall Street*, USA TODAY, Sept. 16, 2008, *available at* http://www.usatoday.com/news/politics/election2008/2008-09-16-campaign-roundup-tuesday_N.htm.

[128] CHOPER, COFFEE & MORRIS, *supra* note 115, at 464 (citing Ronald J. Gilson, *The Outside View of Inside Trading*, N.Y. TIMES, Feb. 8, 1987, at E23).

[129] *Id.*

trading by public figures. In addition to securities fraud, the DOJ indicted Stewart for obstruction of justice and perjury.[130] This was perhaps because the government knew that its securities fraud case for insider trading was weak and was looking for any method of prosecuting a high-profile case. As it turned out, the judge dismissed the securities fraud charge against Stewart.[131] She was convicted, however, on the DOJ's obstruction of justice and perjury charges, leading to a five-month prison sentence, two years of supervised release and a $30,000 fine.[132] Subsequently, the SEC settled its civil insider trading suit against Stewart for just over $58,000 in disgorgement and interest, plus a civil fine in excess of $130,000.[133] So, in the end, while Stewart received only fines for her insider trading activity, the government scored a victory against a public figure through the related charges of obstruction of justice and perjury.[134]

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[130] *See* Press Release, SEC, SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading (June 4, 2003), *available at* http://www.sec.gov/news/press/2003-69.htm.

[131] Gregg Greenberg, *Judge Tosses Fraud Charge Against Stewart*, THESTREET.COM, Feb. 27, 2004, http://www.thestreet.com/print/story/10145967.html (last visited Apr. 26, 2009).

[132] *Stewart sentenced to five months in prison*, SYDNEY MORNING HERALD, July 17, 2004, *available at* http://www.smh.com.au/articles/2004/07/17/1089694573700.html.

[133] Litig. Release No. 19794, Martha Stewart and Peter Bacanovic Agree to Settle SEC Insider Trading Charges (Aug. 7, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/ lr19794.htm.

[134] While Martha appears to have rehabilitated her image, Michael Milken is still waiting for a pardon that would lift the ban on him working as an investment banker. Richard Mo, *Milken Fails to Obtain Presidential Pardon*, DAILY PENNSYLVANIAN, Jan. 22, 2001, *available at* http://media.www.dailypennsylvanian.com/media/storage/paper882/news/2001/01/22/News/Milken.Fails.To.Obtain.Presidential.Pardon-2162412.shtml. Milken recently applied for a pardon from President George W. Bush. Charlie Savage, *Felons Seeking Bush Pardon Near a Record*, N.Y. TIMES, July 19, 2008, at A1, *available at* http://www.nytimes.com/2008/07/19/us/19pardon.html.

H. Conclusion

Used to exploiting discontinuities in markets, hedge fund traders may be disposed to take advantage of loopholes in the insider trading laws. Although many of the possible loopholes are more apparent than real, a few have significant, practical potential. We are aware, for example, of a case in which hedge funds traded in CDSs with the benefit of inside information, but were not charged with insider trading because regulation of such derivative securities fell between the cracks in the jurisdiction of the SEC, CFTC, and other agencies. SEC Chairman Christopher Cox has testified that the inability to regulate CDSs is a "regulatory hole."[135] We can imagine common circumstances in which trading in such securities could serve as a good substitute for trading in other securities that are more likely to be subject to the insider trading laws.

Nevertheless, a hedge fund would be ill-advised to trade on the basis of material, inside information, even when doing so does not technically constitute insider trading. In the aforementioned case, the hedge fund traders, as well as investment bank tipper, got away with this conduct, but still had to incur the time and expense of defending themselves from an SEC investigation. Moreover, they had the good luck in this particular instance that the SEC did not, as it has so often done successfully in the past, creatively and tenaciously pursue opportunities in the facts or the law to punish their conduct. Like them, the trader in the *Barclays* case could have thought that debt securities were outside the scope of the insider trading laws, but he did not have such good luck and was found guilty of violating them.

As demonstrated in the previous sections of this Article, an historical examination of the SEC's enforcement of the insider trading laws shows that, irrespective of limitations in the case law, the SEC has consistently pursued, and usually found ways to eventually punish, persons who do not observe a simple precept: disclose material, inside information or

[135] *See Cox Testimony Concerning Turmoil in U.S. Credit Markets*, *supra* note 99.

refrain from trading. Indeed, over the course of more than four-and-a-half decades, the SEC has done so with a resolve and dedication that, while in a more justifiable way for a more defensible cause, is worthy of Torquemada, the zealous, incorruptible priest who first led the Spanish Inquisition.

For approximately nineteen years, the disclose or refrain from trading precept guided SEC enforcement and was accepted by the courts as the law. Viewed retrospectively in light of the policy arguments against insider trading, the *Chiarella* court's limits on this precept are more surprising than the SEC's resistance to them. In sum, since this case, the SEC has reduced, worked around or overcome the inconsistencies between this broad precept and the narrower case law on insider trading by:

- bringing claims for affirmative representations instead of nondisclosure;

- adopting Rule 14e-3 to overrule *Chiarella's* fiduciary duty limitation in the tender offer context;

- persuading the federal courts to expand, well beyond traditional state law conceptions, the notion of fiduciary duty in insider trading cases to cover constructive fiduciaries or temporary insiders;

- convincing the courts to extend insider trading liability to (i) tippers that, in breach of a duty of confidence to their source, receive a direct or indirect pecuniary or reputational benefit from tipping and (ii) tippees that knew or should have known inside information was made available to them improperly;

- gaining the courts' acceptance of the misappropriation theory of insider trading and the Congress' enactment of Section 20A of the Exchange Act, which gives private plaintiffs standing to sue under it;

- obtaining from Congress the addition of Section 20(d) to the Exchange Act, which renders the insider trading laws applicable to options;

- using, in the *Barclays* case, the misappropriation theory to attack insider trading in debt securities;

- promulgating Regulation FD, as well as Rule 10b5-1 and 10b5-2, to prevent selective disclosure to securities market professionals and close certain loopholes in the insider trading laws left open by the *Dirks*, *Smith*, and *Chestman* cases;

- prompting the DOJ to bring charges of mail and wire fraud or the New York State Attorney General to bring charges under New York's Martin Act, which charges could be used to reach insider trading in CDSs and other financial instruments that do not qualify as securities; and

- as a last resort against scoundrels (or, if you prefer, of scoundrels), prosecuting alleged insider traders for perjury.

Most violations of the SEC's disclose or refrain from trading precept are caught by one or more of these various legal tactics for combating insider trading. As we have indicated above, an arbitrary or insubstantial variation in facts will often determine whether or not the SEC's precept applies. Recognizing that facts and their interpretation are frequently revealed, by the end of litigation, to be different in some significant ways than expected in the beginning, compliance personnel at hedge funds should be extremely wary of reliance on fine factual distinctions to approve trading with inside information. Even when the facts are certain, the full legal analysis of insider trading law is complicated and sometimes debatable,[136] so founding and

[136] *See* Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 65 Fed. Reg.

following a compliance program on the basis of it would be impractical, as well as unrealistic and imprudent. That said, such analysis could occasionally be pertinent and helpful in a sophisticated compliance program when situations of factual and legal uncertainty arise, relating for example to questions about the materiality of information. A hedge fund might be more willing to trade in these situations, and take the risk of misjudging them, if there is also some doubt about the applicability of the insider trading laws in them. Otherwise, for reasons of business reputation as well as legality, hedge funds should simply observe the SEC's precept.

III. WHY MUST A HEDGE FUND HAVE AN INSIDER TRADING COMPLIANCE PROGRAM?

No statute or regulation requires most hedge funds to establish, maintain or enforce an insider trading compliance policy. Unlike broker-dealers and certain investment advisers, hedge funds have largely avoided regulation under the federal securities laws, other than the antifraud provisions, much to the disappointment of the SEC. However, this Article looks beyond requirements, to "best practices" and realities in light of the current regulatory environment. That is to say, what is *required* is not always what is *necessary*, or even in the best interest of an organization. In fact, as argued below, establishing an insider trading compliance policy is in the best interest of both hedge funds and their employees.

A. Is an Insider Trading Compliance Program Required?

Section 15(f) of the Exchange Act requires registered broker-dealers to establish, maintain, and enforce written policies and procedures "reasonably designed" to prevent the misuse of material, non-public information in violation of the

51,716, 51,718 (Aug. 15, 2000) (noting "the legal uncertainties posed by current insider trading law").

Exchange Act or the rules or regulations thereunder.[137] Section 204A of the Investment Advisers Act of 1940, as amended, (the "Investment Advisers Act") places this obligation on "investment advisers" subject to the registration requirements of the Investment Advisers Act.[138]

Historically, many hedge funds have avoided registration under the Investment Advisers Act by relying on the so called "private adviser exemption" in Section 203(b)(3) of the Act. The exemption is available for any investment adviser who (i) has had fewer than fifteen clients during the preceding twelve months; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) is not an adviser to any registered investment company.[139] In 2004, the SEC sought to impose registration requirements on hedge funds by adopting Rule 203(b)(3)-2 of the Investment Advisers Act and related rule amendments. This reform removed the "private adviser exemption" for many hedge funds by requiring hedge fund managers to look through their funds and count each investor as a "client."[140] On June 23, 2006, in *Goldstein v. SEC*,[141] the United States Court of Appeals for the District of Columbia Circuit vacated Rule 203(b)(3)-2 as inconsistent with Congressional intent and the text of the Investment Advisers Act. It ruled that the "client" of an investment adviser managing a pool is the pool itself, not an investor in the pool.[142] In 2007, in response to the decision in *Goldstein*, the SEC adopted Investment Advisers Act Rule 206(4)-8, which prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or

[137] Securities Exchange Act of 1934, 15 U.S.C. § 78o(f) (2006).

[138] Investment Advisers Act of 1940, 15 U.S.C. § 80b-4(a) (2006).

[139] *Id.* at § 80b-3(b)(3).

[140] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 69 Fed. Reg. 72,054,72,058 (Dec. 10, 2004).

[141] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

[142] *Id.* at 880.

prospective investors in those pooled vehicles.[143] In the adopting release, the SEC noted: "This rule is designed to clarify, in light of a recent court opinion, the Commission's ability to bring enforcement actions under the Investment Advisers Act of 1940 against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle."[144]

Since many hedge funds can avoid registration under the Investment Advisers Act through the "private adviser exemption," they are not required to establish, maintain, or enforce written policies and procedures to prevent the misuse of material, non-public information.

B. Is an Insider Trading Compliance Program Necessary?

While many hedge funds are not strictly required to have a compliance program relating to insider trading, they should not therefore conclude that one is unnecessary. As private advisers, they are only exempt from the requirement of written policies and procedures, not the insider trading laws. Hedge funds and their employees are subject to the antifraud provisions of the federal securities laws and SEC rules thereunder, including Section 10(b) and Rule 10b-5 of the Exchange Act. A hedge fund itself may be condemned to pay substantial fines for its insider trading violations. As a controlling person, it may be held liable for insider trading by its employees. Its employees may be punished by jail sentences, as well as civil penalties.

In addition to these legal risks, hedge funds face business risks relating to insider trading. Insider trading convictions against a hedge fund will hurt its reputation, and possibly, as a result, its business. Convictions against hedge fund employees will result in dismissal and poor prospects for attractive employment in the foreseeable future. Because

[143] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. IA-2628, 72 Fed. Reg. 44,756 (Aug. 9, 2007).

[144] *Id.*

human capital is critical in the hedge fund business, the loss of highly-trained employees as a result of their insider trading will be detrimental.

Recent actions and pronouncements by the SEC suggest that the risk of insider trading charges against hedge funds has become even more significant. In a statement to the Senate Banking Committee on July 31, 2007, the Chairman of the SEC announced the creation of a hedge fund working group within its Enforcement Division to combat hedge fund insider trading.[145] Noting in general that the SEC's Enforcement Division is significantly larger that it was five years ago, he specifically emphasized that the SEC had, in the past few years, "brought numerous enforcement actions alleging that hedge fund portfolio managers engaged in insider trading."[146] Consistent with this emphasis, a number of recent cases, including an action in which a hedge fund manager was forced to pay $801,256.70,[147] indicate increased

[145] *Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2007/ts073107cc.htm.

[146] *Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/ 2007/ts073107cc.htm; *see also* David B. Bayless, *Insider Trading Returns*, GC California, Jan.-Feb. 2008 (tracing renewed emphasis on insider trading at least back to September 2006, discussing a number of enforcement actions against hedge funds, and noting at least thirty SEC investigations relating to potential insider trading at hedge funds and other investment advising firms); Emily Thornton, Amy Borrus & Stanley Reed, *More Heat on Hedge Funds*, BUS. WK., Feb. 6, 2006, http://www.businessweek.com/magazine/content/06_06/b3970066.htm (reporting a flurry of probes by the SEC, NASD, and FSA into insider trading by hedge fund employees and the SEC's devotion of substantial resources to these investigations).

[147] Litig. Release No. 20565, SEC, Former Hedge Fund Manager and Investment Adviser Settle SEC Insider Trading Charges (May 12, 2008), *available at* http://www.sec.gov/litigation/ litreleases/2008/lr20565.htm.

pursuit of insider trading violations relating to securities professionals.[148]

Adding fuel to the fire, in January 2008, the Wall Street Journal reported academic studies that some banks are likely trading on inside information about deals.[149] On August 13, 2008, the SEC published for public comment an agreement among the NYSE, NASDAQ, and other stock exchanges that "is designed to improve detection of insider trading across the equity markets by centralizing surveillance, investigation, and enforcement under NYSE Regulation, Inc. (NYSE Regulation) and the Financial Industry Regulatory Authority, Inc. ("FINRA")."[150] More

[148] Narayanan, *supra* note 2; Litig. Release No. 20022, SEC, SEC Charges 14 Defendants in Wall Street Insider Trading Ring, Including Personnel at UBS Securities LLC, Morgan Stanley & Co., Inc. and Bear, Stearns & Co., Inc. (Mar. 1, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20022.htm; Litig. Release No. 19995A, SEC, SEC Charges Family With $3.7 Million Insider Trading Scheme (Feb. 13, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr19995a.htm; Stephen Taub, *Insider Trading Linked to PIPE Offerings*, CFO, Apr. 25, 2005, http://www.cfo.com/article.cfm/3905798/c_3905813?f=TodayInFinance_Inside (last visited Apr. 26, 2009); Litig. Release No. 20331, SEC, Final Judgment Entered Against Spouse of Former Officer of Triangle Pharmaceuticals, Inc. for Illegal Insider Trading (Oct. 12, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20331. htm; Litig. Release No. 20636, SEC, Former Morgan Stanley and ING Investment Management Services Securities Professionals Settle SEC Insider Trading Charges (July 3, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20636.htm; Litig. Release No. 20222, SEC, SEC Files Settled Charges Against a Mutual Fund Manager for Insider Trading That Allowed the Mutual Fund That He Managed to Avoid Close to a Million Dollars in Losses (Aug. 2, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20222.htm; Litig. Release No. 20112, SEC, SEC Charges Two Securities Professionals With Insider Trading (May 10, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20112.h tm.

[149] Mark Maremont & Susanne Craig, *Trading in Deal Stocks Triggers Look at Banks, Study Shows Pattern of Buying by Advisers: 'Benign or Nefarious'?*, WALL ST. J., Jan. 14, 2008, at A1, *available at* http://online.wsj.com/public/article/SB120027840975287629.html?mod=msn_free.

[150] Press Release, SEC, SEC Announces Proposed Plan to Enhance Insider Trading Surveillance and Detection (Aug. 13, 2008), *available at* http://www.sec.gov/news/press/2008/2008-174.htm.

generally, increased scrutiny and regulation of the financial industry has become a dominant public theme as a consequence of the financial crisis. This theme is starkly evident in the SEC's Annual Report for 2008, which emphasizes in particular that the number of insider trading cases was up more than 25 percent over the previous year and represented the highest number of insider trading cases in the SEC's history.[151]

In response to the attention being given to insider trading, especially by hedge funds, Barry Barbash, a former director of the SEC's Division of Investment Management, observed: "When the SEC increases its focus, it's just inevitable that the number of enforcement cases will also increase."[152] For this reason alone, in the current anti-Wall Street, pro-regulation climate, hedge funds should review their insider trading compliance programs or adopt programs if they are not currently in place. Another reason to do so is the signal sent by a recent enforcement action that the SEC will not be tolerant of financial intermediaries which do not have insider trading compliance programs, even if they are technically exempt from the requirement for one. The discussion below examines:

- this enforcement action, the Retirement Systems of Alabama;

- the controlling persons provision in Section 21A of the Exchange Act and the need for insider trading compliance programs; and

- the range of possible penalties for insider trading.

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[151] SEC Annual Report for 2008, *supra* note 99, at 2, 12. The Report also stresses that the proportion of SEC enforcement staff to total staff (one-third), and the SEC's internal allocation of funds for enforcement, in fiscal year 2008 were the highest in the SEC's history. *Id.* at 3.

[152] Edward Hayes, *SEC Hunting Insider Trading in Hedge Funds*, CCH WALL ST., Feb. 21, 2007, *available at* http://www1.cch wallstreet.com/ws-portal/content/news/container.jsp?fn=02-21-07 (quoting Barry Barbash).

1. SEC Warning—The Retirement Systems of Alabama

In 2008, the Division of Enforcement of the SEC investigated whether The Retirement Systems of Alabama ("RSA") violated the federal securities laws by purchasing shares of The Liberty Corporation ("Liberty") on the basis of material, non-public information.[153] Although they rely on a different exemption, state pension funds, like most hedge funds, are exempt from the registration requirements of the Investment Advisers Act.[154] According to the SEC, after receiving material, non-public information regarding the prospective acquisition of Liberty by Raycom Media, Inc., RSA purchased 73,700 Liberty shares during the two weeks prior to the public announcement of the transaction.[155] After the public announcement of the transaction, Liberty's stock price rose significantly, increasing the value of RSA's holdings by more than $700,000.[156]

The RSA cooperated with the SEC and, during the investigation, offered the equivalent of rescission damages to the sellers from whom it bought the Liberty shares.[157] In light of this cooperation and remedial action, the SEC decided not to impose a penalty because it would have been paid from Alabama public employees' contributions to RSA funds.[158] In deciding not to proceed with a cease-and-desist order or permanent injunction prohibiting future violation of the anti-fraud provisions of the Exchange Act, the SEC noted

[153] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, Exchange Act Release No. 34-57446 (Mar. 6, 2008), *available at* http://www.sec.gov/litigation/investreport/34-57446.htm [hereinafter *RSA Report*].

[154] *Id.* at n.13.

[155] *Id.*

[156] *Id.*

[157] *Id.*

[158] *Id.*

these considerations and the fact that the RSA had subsequently adopted a compliance policy.[159]

As a result of its enforcement action against RSA, the SEC issued a report under Section 21(a) of the Exchange Act, which authorizes the SEC to publish information concerning any violations of the Exchange Act that it has found in an investigation. More than three years had elapsed since the last report under this section,[160] so the publication of the RSA report was an exceptional event and underlines the SEC's warning to unregistered investment advisers of the need for insider trading compliance programs. The SEC remarked: "We issue this report to remind investment managers, public and private, of their obligation to comply with the federal securities laws and the risks they undertake by operating without an adequate compliance program. RSA's conduct could have been prevented with appropriate policies, procedures and training."[161] Hedge funds are clearly included in the SEC's reference to public and private investment managers. Nonetheless, having been put on notice by the SEC's report and lacking the public purpose of the RSA, they are unlikely to be let off as lightly as the RSA

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[159] *Id.*

[160] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on Potential Exchange Act Section 10(b) and Section 14(a) Liability, Exchange Act Release No. 34-51283 (Mar. 1, 2005), *available at* http://www.sec.gov/litigation/investreport/34-51283.htm.

[161] *RSA Report*, *supra* note 153. Importantly, the SEC noted:

> Most of the RSA investment personnel involved in this matter, including its CEO, did not have a clear understanding of the securities law duties and risks implicated when they came into possession of material, nonpublic information. RSA had an in-house general counsel, but he was not responsible for securities law compliance and was not consulted before the trades. RSA had outside counsel with considerable securities law expertise, but there was no practice or procedure for the investment staff to seek advice regarding such issues.

Id.

if their failure to implement adequate compliance programs allows insider trading.

2. Controlling Persons Liability

In addition to Rule 10b-5, Section 21A was a basis for the RSA enforcement action. Under Section 21A of the Exchange Act, controlling persons who fail to prevent insider trading may be subject to civil penalties.[162] Specifically, Section 21A of the Exchange Act created control person liability for insider trading violations committed by a corporation or regulated entity's employee.[163] A control person can be liable if:

> (A) such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or
>
> (B) such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 78o(f) of this title or section 80b-4a of this title and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.[164]

In this regard, an insider trading compliance program can act as an "appropriate step to prevent" acts of insider trading before they occur. Thus, in addition to fostering prevention, such a program can serve as a defense or mitigating factor in the event that a violation does occur. As shown above in Part II, the SEC has successfully pursued ways around case law setbacks to persist in enforcing its policies for combating insider trading. Section 21A, together with Investment Advisers Act Rule 206(4)-8, appears to be the way that the SEC can overcome the *Goldstein* case to effectively require

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[162] Securities Exchange Act of 1934, 15 U.S.C. § 78u-1 (2006).

[163] *Id.*

[164] *Id.* at § 78u-1(b)(1).

hedge funds to have a compliance program. Prior to the RSA case, only one other case had been brought under Section 21A.[165] In the future, we may see more active use of it by the SEC, especially with respect to hedge funds.

3. Penalties for Insider Trading

Significant penalties for the violation of insider trading laws are one of the reasons an insider trading compliance policy is necessary. Section 32 of the Exchange Act provides for fines of no more than $5,000,000 (not exceeding $25,000,000 when the violator is not a natural person) and imprisonment of up to twenty years, or both, for any person who willfully violates any provision of the Exchange Act.[166] Settlement agreements can impose additional penalties, including forfeiture of compensation and banishment from a profession, such as (i) the two-year ban from practicing law, working in the securities industry or serving as an officer or director of a public company in the recent case of David Aufhauser, former general counsel for UBS AG's investment bank,[167] and (ii) the lifetime ban from the securities industry in the case of Michael Milken.[168]

Under Section 32 of the Exchange Act the violation must be willful and "no person [can] be subject to imprisonment under [Section 32] for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."[169] However, employee training relating to the insider trading laws would be part of any insider trading compliance program, so an effect of the program will be to

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[165] *See* SEC v. Adelt, Litig. Release No. 18442 (Nov. 3, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18442.htm.

[166] Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) (2006).

[167] Rappaport, *supra* note 120.

[168] Peter Truell, *Milken Settles S.E.C. Complaint for $47 Million*, N.Y. TIMES, Feb. 27, 1998, at A1. The SEC has also barred individuals from associating with any broker, dealer, investment company, investment adviser, or municipal securities dealer under Section 203(f) of the Investment Advisors Act of 1940. *In re* Victor Teicher, 53 SEC 581 (1998), *aff'd in part, rev'd in part*, 177 F.3d 1016 (D.C. Cir. 1999).

[169] Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) (2006).

supply the knowledge element necessary for criminal sanctions. In any event, sophisticated hedge fund employees are unlikely to be believed if they seek to deny knowledge of the insider trading laws.

Criminal cases, with a "beyond a reasonable doubt" standard, are harder to prove than civil cases, which employ a "more likely than not" standard. Moreover, when the only sanctions against an accused person are harsh criminal penalties that are seemingly disproportionate, courts and juries have been known to find ways to let defendants escape punishment.[170] At least, the United Kingdom's regulator, the Financial Services Authority, has observed that enforcement of the insider trading laws in the United Kingdom has been impeded by its inability, until recently, to bring civil as well as criminal charges of insider trading.[171] The SEC does not suffer from such a constraint and its authority to bring civil actions enhances its ability to enforce the insider trading laws. Section 21A(a)(1) of the Exchange Act permits the SEC to bring such an action in a United States district court, and grants the court the power to impose civil penalties.[172] In the case of the person who committed the violation, the damages are determined in light of the facts and circumstances, but cannot exceed three times the profit gained or loss avoided as a result of the unlawful purchase, sale, or communication.[173] Historically, the SEC has utilized a "one plus one" rule under which "settling parties agree to disgorge all trading profits or losses avoided (plus interest) and pay an additional penalty

[170] *See supra* Part II.F.2.a.

[171] *See* Sally Dewar, Dir. of Mkts. Div., Address at the Market Abuse Seminar, (May 22, 2007), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0522_sd.shtml ("It was anticipated that a civil process with the accompanying benefits like a civil burden of proof, a jury not being required, the ability to settle, a quicker process with non-custodial outcomes and the ability to have a specialist Tribunal for difficult issues of fact and law would result in more successful actions against insider dealing.").

[172] Securities Exchange Act of 1934, 15 U.S.C. § 78u-1(a)(1) (2006).

[173] *Id.* at § 78u-1(a)(2).

equal to the amount disgorged (excluding interest)."[174] However, the SEC has utilized its discretion to increase and decrease penalties where appropriate.[175]

The amount of damages imposed on a person who, at the time of the violation, directly or indirectly controlled the person who committed the violation cannot exceed the greater of $1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation.[176]

In addition to the SEC and the DOJ, the insider trading laws may be enforced by private plaintiffs. Section 20A(a) of the Exchange Act provides a private right of action for the violation of any provision of the Exchange Act or the rules and regulations thereunder by purchasing or selling a security while in possession of material, non-public information.[177] Section 20A(b) makes clear that the total amount of damages imposed under Section 20A(a) cannot exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.[178] Under this measure of damages, an insider trader does not face much greater risk than losing his profits from the insider trading, so the threat of private actions against insider trading is much less of a deterrent than that of SEC or DOJ actions.

Nonetheless, private enforcement of the insider trading laws is promoted by the SEC's authority to award bounties to informants. Under Section 21A(e), the SEC or DOJ can award, from penalties imposed, such sums, not to exceed 10 percent of such penalties, as the SEC deems appropriate to

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[174] Stephen M. Cutler, Dir., SEC, Div. of Enforcement, Address at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm.

[175] *Id.*

[176] Securities Exchange Act of 1934, 15 U.S.C. § 78u-1(a)(3).

[177] § 78u-1(a).

[178] § 78u-1(b).

persons who provide information leading to the imposition of an insider trading penalty.[179]

III. WHAT COMPLIANCE POLICIES AND PRACTICES SHOULD BE IMPLEMENTED IN A HEDGE FUND'S INSIDER TRADING PROGRAM?

As we have argued above, hedge funds are best advised to design their compliance programs to follow the SEC's precept: disclose material, inside information or refrain from trading. Observance of this precept should seemingly be simple. A person receiving selective disclosure from an issuer will, under Regulation FD, normally be bound by a confidentiality agreement or duty and, as a result, likely know he has material, inside information.

However, in reality, even the best controlled organizations sometimes fail to prevent unauthorized leaks of information. Therefore, hedge funds may, despite Regulation FD, find themselves in possession of material, inside information when they do not clearly have a confidentiality obligation to its source. This situation may arise if:

- the issuer unknowingly and inadvertently leaks material, non-public information;

- the issuer has become aware of a non-intentional leak of material information, but has not yet made prompt public disclosure of it as required by Regulation FD (which only requires simultaneous disclosure to a particular recipient and the public in the case of an intentional disclosure);

- an investment bank, accounting firm, law firm or other person acting on behalf of the issuer has, unbeknownst to the issuer, leaked material, non-public information;

[179] § 78u-1(e). *See infra* Part IV.C.

- the issuer selectively discloses material, non-public information to a journalist or other person not covered by Regulation FD and such person leaks it to others; or

- the issuer simply does not comply with Regulation FD.

A leak of material, inside information will, in some of these circumstances, result from an issuer's violation of Regulation FD or another person's breach of a confidentiality obligation, but this fault will not excuse a hedge fund's insider trading on the basis of it.

Since uncontrolled leaks of material, non-public information may occur despite Regulation FD, implementation of the SEC's disclose or refrain precept will not always be obvious or straightforward. In particular, it will not always be clear whether information qualifies as inside in nature or material.

A. The Inside Element of the SEC's Disclose or Refrain Precept

1. Compliance Policy in the Confidentiality Context

In designing an insider trading compliance program, a hedge fund should, as implied above, start with the establishment of an internal process for managing and approving its entry into confidentiality agreements or engagements with related confidentiality duties.[180] A confidentiality obligation may prevent a hedge fund from revealing material, inside information. Trading would

[180] Such a process for managing confidentiality obligations is, apart from insider trading considerations, often regarded as a good internal control by organizations, such as investment banks and law firms, that (i) repeatedly encounter confidentiality demands, (ii) wish to avoid setting bad precedent for themselves and (iii) can benefit from the efficiency of some standard procedures in this area. These factors alone may convince some hedge funds of the need for such a process. Further, insider trading concerns should make the establishment and conscientious operation of such a process compelling.

therefore be precluded, since doing so without this necessary disclosure would violate Rule 10b-5. For this reason, in the pre-bankruptcy context hedge funds will often seek, in return for their confidentiality obligation, a "cleansing provision" from a distressed company that supplies them with inside information in connection with a possible restructuring transaction. Under this provision, the distressed company will agree to make public, at the hedge fund's request, such inside information.

Outside of the restructuring context, companies will usually succeed in resisting a cleansing provision. In particular, they will not want to be obligated to make projections public and hedge funds will acknowledge the risks of securities fraud suits associated with their publication. Alternatively, to be free to trade, some hedge funds may adopt general policies of overtly refusing to enter into confidentiality agreements. This approach may sometimes accomplish this goal by arguably eliminating the fiduciary duty and duty of confidentiality on which the classical and misappropriation theories respectively repose. However, it should not be considered a foolproof method for avoiding an insider trading violation.[181] Since the existence of a fiduciary duty is not a condition for a Rule 14e-3 claim, rejection of confidentiality obligations will not prevent an insider trading violation relating to material, non-public information about a tender offer. With respect to inside information about any matter, such rejection may not defeat a claim under the tippee theory of insider trading in circumstances where the argument might still be made that the hedge fund should have known that the inside

[181] For example, in its investigation report in RSA, the SEC observed that RSA had "a general policy of not entering into confidentiality agreements because of state public access laws" and that "RSA neither asked to see the NDA [between Liberty and its advisors] nor inquired about its terms." *RSA Report*, *supra* note 153, at 3 n.4. The existence of this general policy did not exonerate the RSA from the SEC's insider trading charges.

information was made available to it improperly.[182] Moreover, as demonstrated above in Part I, the SEC does not look kindly upon the duty to disclose limitations in the Court's insider trading theories and has frequently overcome them one way or another.

A process for approving and managing confidentiality obligations is also important, because material, inside information received by one person or department at a hedge fund may be imputed to other persons or departments at the fund. These other persons or departments may trade without knowledge of such information, but still put the organization as a whole at risk of an insider trading violation. As further discussed below, this risk may be handled to some extent by "Chinese Wall" procedures, ensuring that such information does not pass from one distinct person or group to another.

For circumstances in which Chinese Walls are not considered adequate to address this risk from imputation of knowledge, a hedge fund should have restrictive list procedures whereby trading in certain securities is precluded when the organization has material, inside information relating to them. These procedures would typically involve a process for determining what securities should be put on a restricted list and a mechanism for preventing trading in them. Restrictive list controls might be preceded and preconditioned by controls for resolving conflicts between the hedge fund's interest in free trading opportunities and in business subject to confidentiality obligations, which business could deprive the hedge fund of trading opportunities.

Material, inside information of the hedge fund as a whole may be imputed to its employees or tippees of the employees, creating potential insider trading problems both for the hedge fund and the employee. In this regard, hedge funds and their employees should be mindful that the appearance of insider trading may be as much of a problem as its actual occurrence as known by them internally. The hedge fund

[182] Questions might also be raised about the extent to which a rejection of confidentiality obligations may allow a shareholder to contract out of a fiduciary duty to other shareholders.

should therefore have procedures for clearing individual trading by employees and ensuring their respect of confidentiality restrictions on the hedge fund's information. These clearance and confidentiality procedures would also help address the risk of the hedge fund being held responsible for unauthorized tipping by employees.

2. Compliance Policy in the Non-Confidentiality Context

Traders should be educated to understand that, given Regulation FD, they are not generally supposed to receive non-confidential, non-public information. If they do, their usual reflex should be to consult a compliance person before trading on it. The strong desirability, if not necessity, of consultation might be considered absent when the information is clearly immaterial, but traders should be warned that materiality judgments are often not self-evident.[183] They should be especially cautious if the information comes from a permanent or temporary insider, such as a director, officer, or employee of an issuer, or its accounting firm, consulting firm, law firm, or investment bank.

In the event that an insider is not the apparent source of the trader's non-public information, then the trader, together with a compliance person, will likely be confronted with the question of distinguishing rumors from inside information. In theory, this distinction might be made by reference to the existence or absence of a duty to disclose assumed by the trader; absence of such duty would mean the information could be regarded as a rumor that did not preclude trading. In practice, tracing a duty to disclose back to the issuer under the tippee theory of insider trading can be as complex and murky as tracking the spread of a mysterious virus of uncertain origins. Moreover, as shown in Part II, the SEC has tended to be skeptical and resistant towards the limits on its "disclose or refrain" precept resulting from the concept of a duty to disclose. Therefore, as explained below, a

[183] *See infra* Part III.B.

materiality analysis will usually be used to determine whether non-public information constitutes a rumor and, as such, is not a bar to trading. For assistance in making this determination, the hedge fund may find it helpful to consult the Market Abuse Directive, which directly addresses the issue with its concept of information of a precise nature.[184]

To help traders comprehend the rationale behind the insider trading laws and reconcile themselves to it, hedge funds may highlight to them the difference between information advantage from superior analysis and that from unfairly privileged access. Traders can be assured that material, non-public information may, without access to insiders, be generated by their analysis of public information. In addition, traders may be told of the mosaic theory that allows generation of material, non-public information from immaterial, inside information. However, they should be cautioned to not rely on this theory without enlisting the assistance of a compliance person in determining whether such reliance is appropriate in given circumstances.

3. Compliance Policy for Deciding when Information Ceases to be Non-Public

If a determination has been made that a trader possesses material, inside information that precludes him from trading, the trader will want to know what disclosures must be made so that he can trade on that information. The key insight here is that the analysis in this "insider" scenario may differ from that in a scenario where the trader first learns of the information from a Bloomberg screen, press release, SEC filing, or other form of public communication. Normally, an outsider may consider information to be public the moment after its publication. However, a clever trader with inside information might effectively trade on it by reacting to its publication more quickly than anyone else is able. This "too cute" approach runs the danger of falling afoul of the insider trading laws. According to the SEC, "[i]t

[184] *Market Abuse Directive*, *supra* note 11.

is well established that information is non-public if it has not been disseminated in a manner making it available to investors generally."[185] With regard to issuers, the SEC has observed, with support in the case law, that for information to be public "it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."[186] With regard to persons with inside information, the SEC and the courts would likely take the same position.

B. The Materiality Element of the SEC's Disclose or Refrain Precept

In deciding whether they have material, inside information posing insider trading issues, hedge fund traders should ask, as a threshold question, whether the information is non-public information. The answer to this question should usually be clear and easily obtained, allowing them to decide whether or not they should confer with a compliance person. As explained in the section immediately above, not all non-public information will be considered inside information, but this distinction should only be drawn by someone with expertise in the insider trading laws. Furthermore, except in obvious cases of immaterial information, such a person should also be consulted about materiality judgments. Indeed, these judgments cannot, in principle, be made without the advice of a lawyer, because the courts have held that the issue of materiality is a "mixed question of law and fact."[187]

However, traders are well-qualified to help analyze materiality issues relating to information held by persons

[185] Selective Disclosure and Insider Trading, Securities Act Release No. 33-7787, Exchange Act Release No. 34-42259, 64 Fed. Reg. 72,590 (Dec. 20, 1999).

[186] *Id.* at 72,595 n.40 (citing *In re* Certain Trading in the Common Stock of Faberge, Inc., 45 S.E.C. 249, 255 (1973)).

[187] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

other than an issuer. Specifically, they should have experience and expertise in judging whether information, if known, would have a significant effect on the price of an issuer's securities. The U.S. courts have not explicitly used this standard to define materiality, but it provides highly useful guidance in addressing materiality issues in the insider trading context. As further explained below in Part III.B.2, this standard accords with the concept of price sensitive information in the Market Abuse Directive, which concept cannot only be interpreted as consistent with the U.S. notion of materiality, but serves to generate insight into its meaning in the insider trading context.

Nonetheless, materiality judgments must ultimately be made on the basis of the following law and SEC interpretation regarding the meaning of materiality. Under the U.S. securities laws, information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to purchase or sell securities.[188] Put another way, there must be a substantial likelihood that the disclosure of the information would have been viewed by the reasonable investor as having significantly altered the total mix of information available.[189]

In particular, the materiality of contingent or speculative events "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[190] Practitioners commonly employ this test to find that uncertain information is immaterial when it has a sufficiently low probability of proving to be a correct expectation. Information may be uncertain and immaterial because it concerns developing news. That is, reporting of it may prove to be misleading and, for this reason, the information is not yet ripe for disclosure.

[188] Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988). *See also* SEC Staff Accounting Bulletin No. 103, 68 Fed. Reg. 26,840, 26,856 (May 16, 2003).

[189] *Basic*, 485 U.S. at 231.

[190] *Id.* at 238 (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 849 (2d Cir. 1968)).

Information may also be uncertain and immaterial because its quality is doubtful. In other words, it may just be a rumor.

The U.S. Supreme Court has rejected any bright-line rules for materiality, holding that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive."[191] Accordingly, in Staff Accounting Bulletin No. 103, the SEC emphasized that misstatements in financial statements are not immaterial simply because they fall beneath a numerical threshold. For example, the following qualitative facts could be material despite their failure to rise above a quantitative threshold:

- negative factors affecting a relatively small, but rapidly growing, part of the company's business;
- an adverse circumstance that cannot be measured precisely;
- small intentional misstatements used to manage earnings; and
- evidence of illegal acts, in particular ones that raise doubts about the probity of the company's management.[192]

Nevertheless, the SEC has indicated that it has no objection to the use of a numerical threshold, like five

[191] *Id.* at 236; *see also* Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,716, 51,721 (Aug. 24, 2000) ("While we acknowledged in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of 'material items' for purposes of Regulation FD.").

[192] *See* SEC Staff Accounting Bulletin No. 103, 68 Fed. Reg. 26,840, 26,859.

percent of net income, as an initial step in assessing materiality.[193]

In the final release for Regulation FD, the SEC flagged the following items as "types of information or events that should be reviewed carefully to determine whether they are material":

- earnings information;
- mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
- changes in control or in management;
- change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report;
- events regarding the issuer's securities—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and

[193] The SEC comments that:

> The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a 'rule of thumb' as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations.

Id. at 26,856.

- bankruptcies or receiverships.[194]

In addition, the prospect of a securities offering should be highlighted as information that is potentially material, though the size and nature of the deal may need to be known for this information to be material.

The foregoing items are not an exhaustive list, but may be cited to alert hedge fund traders to potential red flag issues and indicate to them when to seek additional guidance.

In reaching materiality judgments, hedge funds should also consider the issuer's reporting cycle and the time of its last disclosure update. If the issuer's latest public report was not recent, that indicates its disclosure could be out-of-date and possibly explains why a hedge fund may have material, inside information. On the other hand, if the issuer has recently made public disclosure and the information in question was not contained in it, then this may suggest that the information was not deemed to be material by the issuer. However, this possibility could not be readily surmised if the information is of a type that an issuer may wish to keep confidential, such as the possibility of a future merger or acquisition. An issuer's desire to maintain the confidentiality of information is usually not satisfactory grounds for its non-disclosure,[195] but the issuer will be strongly inclined, and may have plausible justification, to take the position that the confidential information is not yet ripe for disclosure.

C. Whistleblowing of Insider Trading Violations

Compliance officers are sometimes placed in the difficult situation of being told by traders that their views are too

[194] Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,721.

[195] The Freedom of Information Act and SEC regulations provide means for requesting confidential treatment of information filed with the SEC. *See* Freedom of Information Act, 5 U.S.C. § 552 (2006); *see also* 17 C.F.R. § 240.24b-2 (2008).

conservative and are inconsistent with "market practice." In response, compliance officers may observe that insider trading is profitable, so a "race to the bottom" may occur where inappropriate conduct is condoned as "market practice" until a regulatory crackdown. So that the hedge fund is not disadvantaged by maintaining necessary standards that are higher than dubious market practice, it could report to the authorities market practice that seems to be in violation of the insider trading laws.

With the risk of this race to the bottom seemingly in mind, the insider trading laws offer some encouragement for whistleblowing. Section 21A(e) of the Exchange Act grants the SEC the authority to award bounties to informants who provide information "leading to the recovery of a civil penalty from an insider trader, from a person who 'tipped' information to an insider trader, or from a person who directly or indirectly controlled an insider trader."[196] Bounties under Section 21A(e) may not exceed 10 percent of the penalty paid by the insider trader, tipper, or controlling person and the SEC's determination is final and not subject

[196] SEC, Insider Trading: Information on Bounties, http://www.sec.gov/divisions/enforce/insider.htm (last visited Apr. 26, 2009); 15 U.S.C. § 78u-1(e) (2006). Section 21A(e) provides:

> Notwithstanding the provisions of subsection (d)(1) of this section, there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

§ 78u-1(e).

to judicial review.[197] For example, in 2002, the SEC awarded John L. Skipper a $29,000 bounty for providing information and testimony leading to the imposition and collection of civil penalties in connection with insider trading by individuals aware of possible financial fraud at Assix International, Inc.[198] The concept of whistleblowing is also found in the Market Abuse Directive, which imposes an affirmative duty to report insider trading in the form of suspicious activity reports.[199]

Although certain funds may seek to end a competitor's illegal gains through informing and applying for bounties, other funds may view reporting as an undesirable alternative with potentially harmful business consequences. Instead of reporting, hedge funds might seek to develop industry guidelines on insider trading and mechanisms for addressing violations. In light of the current pressure for increased regulation of the financial sector, guidelines might even have the effect of preempting and avoiding overly burdensome regulation of hedge funds. Whether hedge funds decide to report violations or seek an alternative solution, management should make a determination on the appropriate course of conduct and effectively communicate that determination to their employees.

D. Potential Qualifications to the SEC's Disclose or Refrain Precept

1. "Chinese Walls"

"Chinese Walls," or "information barriers," are a potential exception to the general rule of disclose or refrain from trading, because they allow trading even though some group within an organization has material, non-public information that could be attributed to the entity as a whole. A "Chinese

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[197] *Id.*

[198] SEC, *SEC Awards $29,000 as Bounty in Insider Trading Case*, 2002 SEC NEWS DIG. 75 (2002), *available at* http://www.sec.gov/news/digest/04-18.txt.

[199] *Market Abuse Directive*, *supra* note 11.

Wall" comprises internal policies and procedures for segregating information in a particular department so that it is unknown and "walled off" from another department.[200] A classic example is the separation in a bank between (i) its M&A advisory division, which will often learn of material, inside information from its work for corporate clients on acquisitions, and (ii) its client or proprietary trading division, which is legally restricted from trading if it knows such information. Thus, a Chinese Wall mitigates the risk of an institution being found guilty of insider trading violations by enabling it to point to the information barrier as proof that it did not really know material, insider information when it traded. Like an insider trading compliance program in general, it also reduces liability exposure by helping an institution distinguish systemic or other shortcomings attributable to it as a collective organization and isolated, exceptional cases of employee misbehavior attributable to individual failings.[201]

Since the SEC's "first indication that Chinese Wall procedures might constitute an adequate mechanism" in *In*

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[200] Characteristics of "Chinese walls" include:

> i) physical separation of departments in different wings or floors of a building; (ii) maintenance of separate accounting systems, records, and support staff; (iii) clearly identifying sensitive documents, employing secure filing systems, and restricting access by persons in departments where a breach of confidentiality could occur, such as a bank's trust department or a broker-dealer's trading section; (iv) limiting attendance at meetings where sensitive topics will be discussed; (v) restricting the transfer of personnel from one department into another; (vi) restricting directors, officers and employees from serving dual roles in more than one market sensitive area, such as the arbitrage and underwriting sections of a broker-dealer; and (vii) using code names in documents to conceal the identity of issuers.

Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1804 (1994).

[201] *See supra* Part III.B.

re Merrill Lynch, Pierce, Fenner & Smith, Inc.,[202] the SEC has recognized "Chinese Walls" are appropriate preventative measures.[203] In fact, the General Counsel of the SEC has observed that "violations of the federal securities laws stemming from these conflicts can be avoided through the use of well-established preventive policies and procedures, such as Chinese Walls, restricted lists and watch lists."[204] The SEC's position is unsurprising, since it is impossible without Chinese Walls to implement the multi-service or universal bank model that has been the trend in the banking industry for many years and is emerging even more strongly as a result of the current financial crisis. Correspondingly, extensive guidance on Chinese Walls exists for this kind of model, including from the SEC and the Treasury Department.[205]

The problem for many hedge funds is that they do not fit well within this model. Not only are many hedge funds comparatively small institutions that, despite their considerable amount of financial assets under management, do not have large staffs, they also are not bureaucratically organized like banks in segregated, functional departments and are under enormous pressure from investors to keep administrative costs to a minimum. Indeed, even compliance personnel at many hedge funds have multi-functional roles that make Chinese Walls impossible in many cases. Chinese Walls would be conceivable for some hedge funds in some cases if one were to accept that they can be implemented on an ad hoc, erect-as-you-go basis. The difficulty for many

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[202] *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968).

[203] Steinberg & Fletcher, *supra* note 200, at 1803-04.

[204] *Id.* at 1810 (citing Koppers Co., Inc. v. Am. Express Co., 689 F. Supp. 1413, 1415 (W.D. Pa. 1988)).

[205] *See, e.g.*, SEC, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information (Mar. 1990), *available at* http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf; Policy Statement Concerning Use of Inside Information, 43 Fed. Reg. 12,755 (Mar. 17, 1978).

hedge funds is that there is considerable legal doubt about such acceptability.

A Chinese Wall works to prevent insider trading violations, but not an Indonesian puppet screen or hippie bead curtain. Chinese Walls are rightfully regarded with a high degree of skepticism by outsiders,[206] so their procedures are at risk of being found ineffective, unless they are especially rigorous both in their design and implementation. For example, in a recent Australian case, *ASIC v. Citigroup Global Markets Australia Pty Limited (No 4)*,[207] ASIC alleged a breach of fiduciary duty and insider trading as a result of a breach in Citigroup's "Chinese Wall." Despite strong separation procedures, the breach occurred because the Chinese Wall did not prevent the head of Citigroup's equity derivatives from providing information to a trader when they happened to meet "outside the firm's Sydney office for a cigarette break."[208] Although Citigroup's Chinese Wall was ultimately found adequate, significant cost and time was spent defending against the allegations. The case is illustrative both of the tendency to view Chinese Walls with suspicion and the demands for permanent, ongoing and robust procedures. In deciding what characteristics a "Chinese Wall" must have to be considered effective, the court's observations under Australian law are consistent with the U.S. perspective in its emphasis on the following:

- physical separation by departments;
- educational programs (that are regularly repeated);

[206] Note, for example, that the professional rules of ethics for lawyers do not, in general, accept Chinese Wall procedures, presumably because self-regulation by interested persons cannot be trusted.

[207] ASIC v. Citigroup Global Markets Australia Pty Limited (No. 4) [2007] FCA 963.

[208] Bloomberg News, *Citigroup Unit in Australia Cleared of Insider Trading*, N.Y. TIMES, June 28, 2007, *available at* http://www.nytimes.com/2007/06/28/business/worldbusiness/28citigroup.html; Thomas Ritchie, *ASIC v. Citigroup: An Amber Light For Proprietary Trading*, CORP. GOV. EJOURNAL (2008), http://epublications.bond.edu.au/cgej/11.

- procedures for dealing with 'crossing the wall;'
- monitoring by compliance officers; and
- disciplinary sanctions for breaching the wall.[209]

Unless they can assure these features of a Chinese Wall, hedge funds should not place much, if any, reliance on an information barrier as an antidote to the insider trading laws.

2. "Big Boy" Letters

As underlined above, a hedge fund may be confronted by the problem that a confidentiality agreement prevents it from revealing material, inside information while the insider trading laws require it to disclose such information or abstain from trading. Faced with this problem, traders have naturally thought of the possible solution that, instead of providing a counterparty with the material, inside information in their possession, they might satisfy both their disclosure and confidentiality obligations by simply warning the counterparty of their inability to do so. The tool for effecting this *caveat emptor* approach has become known as a "big boy" letter. The recipient of the letter, the trader with confidential, inside information, obtains from his counterparty signature of and agreement to it. The letter's essential terms consist of (i) a representation by the counterparty that it is financially sophisticated, *i.e.*, a "big boy," and (ii) an acknowledgment of the counterparty that it will not be privy to material, non-public information known by the trader. To paraphrase the United States Court of Appeals for the Ninth Circuit in *McCormick v. Fund American Companies, Inc.*, a "big boy" letter allows the trader to show that "since [the] plaintiff 'knew what he didn't know,' there was nothing misleading in the omission."[210] It

[209] *See* Ritchie, *supra* note 208.

[210] McCormick v. Fund Am. Cos., Inc., 26 F.3d 869, 880 (9th Cir. 1994).

would also allow the trader to show that the counterparty was not relying on information from the trader. A private cause of action under Rule 10b-5 should not be available, because a deceptive act or omission by the defendant, and detrimental reliance by the plaintiff, are both essential elements of such an action.

However, the efficacy of a big boy letter has been called into question by two recent cases: *SEC v. Barclays Bank Plc*,[211] which is also discussed above in Part II.E, and *R² Invests. LDC v. Salomon Smith Barney Inc.*[212] In *Barclays*, a trader "used purported 'big boy letters' to advise his bond trading counterparties that Barclays may have possessed material non-public information,"[213] but did not disclose this information that it received from creditors committees of distressed companies.[214] Since the big boy letters were obtained in only a few instances, the SEC's insider trading charges would not have been defeated by a defense that the letters were ineffective against them. Nonetheless, while the SEC did not have to take a position on big boy letters to prosecute the case, it made clear that it considered this defense invalid in later commentary, as further described below.

In *R² Investments*, the defendant was a noteholder that, in connection with restructuring discussions with the debtor, entered into a confidentiality agreement and came into possession of material, inside information.[215] The defendant noteholder sold its notes pursuant to a big boy letter.[216] The investment bank, also a defendant, in turn sold the notes to

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[211] SEC v. Barclays Bank PLC, No. 07 CV 4427 (S.D.N.Y. May 30, 2007).

[212] Glenn E. Siegel & Davin J. Hall, *Confidentiality and Disclosure in Distressed Investing*, 24 THE REV. OF BANKING & FIN. SERVICES 1, 2 n.5 (Jan. 2008) (citing R² Invest. LDC v. Salomon Smith Barney Inc., Case No. 01-03598 (S.D.N.Y. 2001)).

[213] Complaint at 4, *Barclays Bank PLC*, No. 07 CV 4427.

[214] *Id.* at 4-5.

[215] Siegel & Hall, *supra* note 212 (citing R² Invest. LDC v. Salomon Smith Barney Inc., Case No. 01-03598 (S.D.N.Y. 2001)).

[216] *Id.*

the plaintiff, though it did not itself obtain a big boy letter or disclose it was party to one.[217] The facts highlight the specific risk that parties to a big boy letter are vulnerable to suit by downstream purchasers which are unaware of the letter. At a minimum, therefore, a recipient of a big boy letter should require the letter's provider to insure that subsequent purchasers agree to its terms. Going beyond this specific issue, the case apparently raises general doubts about the validity of a big boy letter, even in the context of private actions for insider trading. Glenn E. Siegel and Davin J. Hall report that:

> The court found that the big boy letter did not insulate the [plaintiff] from liability as a matter of law and that it did not provide a defense to the claims of the plaintiff under the misappropriation theory. Indeed, the court suggested that the letter might even be evidence of trading with misappropriated information.[218]

In the aftermath of *Barclays* and the ensuing debate about big boy letters, the SEC evoked this kind of misappropriation theory for its position that "big boy" letters are no defense to an SEC enforcement action, even if they might serve as a defense against a private cause of action.[219] The SEC observed that, unlike a private plaintiff, it does not have to show reliance. More importantly, it explained that

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[217] *Id.*

[218] *Id.* at 3.

[219] Rachel McTague, *'Big Boy' Letter Not a Defense to SEC Insider Trading Charge, Official Says*, 39 SEC. REG. & L. REP. (BNA) 1832 (Dec. 3, 2007); Rachel McTague, *In Insider Trading Case, Big Boy Letter Signatory Need Not Have Been Deceived, Official Says*, 39 SEC. REG. & L. REP. (BNA) 1893 (Dec. 10, 2007); [hereinafter *Big Boy Letter Signatory Need Not Have Been Deceived*]. Notably, most of the relevant cases concern waivers akin to big boy letters that have been used in the private M&A context. If big boy letters may be unenforceable in this private context, where extensive agreements are thoroughly negotiated between sophisticated parties, it is even less likely that they would be found appropriate in other, public contexts.

the required element of deception for a Rule 10b-5 claim under *Chiarella* and *Dirks* can be satisfied with proof that the defendant deceived the source of the material non-public information or, by not disclosing exactly what this information was, the counterparty.[220] Law firm partners on the other side of the debate have taken the contrary view.[221] However, as we have demonstrated above, traders ignore the SEC's position at their peril.

The efficacy of big boy letters is also doubtful under the case law, though there is no decision on this precise issue. In private rights of action, some courts have voided blanket waivers under Section 29(a) of the Exchange Act, which prohibits parties from opting out of the federal securities laws or contracting around them.[222] However, other courts have enforced waivers of detrimental reliance when they are coupled with a disclosure of the potential possession of material, non-public information.[223]

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[220] *Big Boy Letter Signatory Need Not Have Been Deceived*, *supra* note 219, at 2-3.

[221] *See id.* at 2.

[222] *See, e.g.*, AES Corp. v. Dow Chem. Co., 325 F.3d 174, 181 (3d Cir. 2003) (interpreting Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a) (2006)).

[223] Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996). As justification for finding reliance waivers to be enforceable in the context of M&A agreements with extensive representations, courts have taken the position that they constitute a "weakening" of the party's right to bring a Rule 10b-5 claim, not a complete waiver of that right in violation of Section 29(a) of the Exchange Act. In *Harsco* the court reasoned:

> There can be no question that the Agreement "weakens" Harsco's ability to recover under the Act. . . . We think, however, that in the circumstances of this case such a "weakening" does not constitute forbidden waiver of compliance. Here there is a detailed writing developed via negotiations among sophisticated business entities and their advisors. That writing, we conclude, defines the boundaries of the transaction.

Id. at 343; *see also* McCormick v. Fund Am. Cos., Inc., 26 F.3d 869, 880 (9th Cir. 1994); Jensen v. Kimble, 1 F.3d 1073 (10th Cir. 1993).

E. Compliance Programs

This Article does not focus on the details of compliance programs, as opposed to compliance policies and their application as discussed above in this section. In brief, note that compliance programs for hedge funds with limited staff will likely have the following key characteristics:

- written guidelines concerning the receipt of material, inside information and the maintenance of its confidentiality, including restricted lists;

- a compliance officer, or officers, to ensure written guidelines are followed and enforced;

- clearance procedures for investments by employees for their own accounts; and

- employee training.

Since compliance programs must be observed and enforced, they need to be tailored to each organization. For this reason, it will generally be better to have a simple, but sufficient, program rather than an overly ambitious one not put into practice. For the same reason, any compliance program should at least be reviewed annually for its adequacy and effectiveness.

V. HOW SHOULD INSIDER TRADING BE UNDERSTOOD IN LIGHT OF THE GLOBALIZATION OF CAPITAL MARKETS?

Some hedge funds have offices in London and other financial centers. Many hedge funds are accustomed to trading in international markets and using offshore entities for tax reasons. In short, globalization of capital markets is a phenomenon that hedge funds do not, and cannot, ignore.

If a hedge fund with U.S. operations conducts business or trades outside of the United States, it should be aware of the extent to which there are, or are not, potential opportunities

to escape the jurisdiction of the U.S. insider trading laws. For example, it might do so when it possesses information that is probably, but not certainly, immaterial and prefers not to take a risk, even if small, of the application of the U.S. insider trading laws. In any event, compliance personnel at hedge funds will want to dispel their traders' misconceptions about the potential applicability of insider trading laws to activity outside the United States. Perceptions of opportunity where one really does not exist could lead to legally dangerous conduct. For instance, loopholes in the U.S. insider trading laws, such as those pertaining to trading in debt and certain derivative securities, may not be present in foreign insider trading laws.

In addition, hedge funds with international operations also need to be cognizant of the risks of being subject to the insider trading laws of both the United States and another jurisdiction. They should not assume that, because trading occurred outside the United States, the SEC and private plaintiffs lack jurisdiction.[224] In addition, European regulators may have jurisdiction even though the trading occurred in the United States. Hedge funds with international operations need to be attentive to the increased collaboration between the SEC and foreign regulators.[225] In addition to increased collaboration, the SEC is actively training foreign regulators to address insider trading.[226]

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[224] The SEC's international work increased significantly during its 2008 fiscal year. SEC Annual Report for 2008, *supra* note 99, at 5-6.

[225] The SEC's increased collaboration with foreign regulators includes coordinated regulation and investigation assistance through multilateral arrangements. *Id.* at 3-4 (indicating that the SEC's temporary short selling restrictions "were taken in close consultation with other regulators around the world"); *id.* at 5-6 (indicating that the SEC's "international work was more significant in FY 2008 than ever before," including 556 requests of foreign regulators for assistance with SEC investigations and 454 requests from foreign regulators for enforcement assistance). In addition, assets frozen abroad in SEC cases through coordination with foreign regulators increased from $11 million in 2007 to $18 million in 2008. *Id.* at 34.

[226] SEC's International Technical Assistance Program, http://www.sec.gov/about/offices/oia/oia_emergtech. htm (last visited Apr. 26, 2009).

Section A below examines the circumstances under which the U.S. insider trading laws may be applied extraterritorially.

Section B discusses the Market Abuse Directive. The insider trading laws of the European Union's twenty-seven member states are, or will be, determined by this Market Abuse Directive. It is therefore relevant in and of itself, because of the large part of the economic world that it covers. It is also interesting because, short of an extensive multi-country survey, understanding the Market Abuse Directive, together with the U.S. insider trading laws, seems to be the best way to generally and practically achieve some sort of preliminary, global perspective on insider trading laws; that is, some kind of rules of thumb regarding what is likely to ensure compliance with these laws in global capital markets.

Insider trading laws in major Asian financial centers, such as Japan,[227] Hong Kong,[228] and Singapore,[229] for

[227] In May 1988, the Japanese Diet amended the Japanese Securities and Exchange Law to strengthen penalties for insider trading. Tomoko Akashi, *Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296, 1303-05 (1989). These provisions, Articles 190-2 and 190-3, are now located in Article 166 of the Securities and Exchange Law. *See* Richard Small, *From* Tatemae *to* Honne*: A Historical Perspective on the Prohibition of Insider Trading in Japan*, 2 WASH. U. GLOBAL STUD. L. REV. 313 (2003); Shoken torihiki ho [Securities and Exchange Law], Law No. 25 of 1948, art. 166, *amended by* Shoken torihiki ho ichibu o kaisei suru horitsu [Law amending in part the Securities and Exchange Law], Law No. 75 of May 31, 1988. Japanese insider trading prohibitions have historically not been extensively enforced. *See* Small, *supra* note 227; *see also* Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 83-85 (2002). Recently, however, enforcement efforts have increased. Hiroyuki Yamato, *Securities Firms Face Increased Enforcement*, *in* SUPPLEMENT—THE IFLR GUIDE TO JAPAN 2006 (Jan. 1, 2006), *available at* http://www.iflr.com/Article/1984689/Securities-firms-face-increased-enforcement.html.

[228] *See* Securities and Futures Ordinance, Cap. 571, §§ 285-89, (2003) (H.K.).

[229] In Singapore, prohibitions against insider trading are set out in Sections 218 ("Prohibited conduct by connected person in possession of inside information") and 219 ("Prohibited conduct by other persons in possession of inside information") of the Securities and Futures Act of 2001. Securities and Futures Act, §§ 218, 219 (2001) (Singapore).

example, are beginning to come into line with those in the United States and Europe. While it is true that insider trading regimes in Asia are more recent developments, it is precisely this late development that has allowed Asian countries to incorporate many of the principles of U.S. and European insider trading laws, but with simpler language and fewer of the loopholes that complicate the U.S. system.[230] Asia has historically been lax in the enforcement of its insider trading laws, but this lack of enforcement in the past is not necessarily an indication of future practice. In a sign that the Asian insider trading environment may be changing, in March 2009, a "former banker with BNP Paribas Peregrine Capital [was] convicted in Hong Kong's first criminal trial for insider trading."[231]

In light of both the growing convergence of global insider trading laws and the increased vigor with which those laws are being enforced, both the U.S. insider trading laws and the European Market Abuse Directive provide important starting points for an analysis of the insider trading regime of any jurisdiction in the world. Armed with knowledge of the U.S. and European systems, hedge funds should be able to ask many of the right questions and better comprehend the answers about foreign insider trading laws that may be applicable to them. In addition, they will be able to make tentative assumptions about the extent to which risks or opportunities relating to these laws may or may not exist.

A. Extraterritorial Application of the U.S. Insider Trading Laws

Section 10(b) and Rule 10b-5 of the Exchange Act require "the use of any means or instrumentality of interstate

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[230] Examples include debt and debt-linked securities. *See supra* Part II.F.3.

[231] Kelvin Wong, *Former BNP Paribas banker convicted in Hong Kong insider trading case*, BLOOMBERG.COM, Mar. 12, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601080&sid=aQyE_1PjpZNo&refer=asia.

commerce or of the mails, or of any facility of any national securities exchange."[232] Section 3(a)(17) of the Exchange Act broadly defines interstate commerce as:

> trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof. The term also includes intrastate use of (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality.[233]

Although the Exchange Act is silent as to extraterritorial application, courts have held that "subject matter jurisdiction may extend to claims involving transnational securities frauds."[234] In *SEC v. Berger*, the United States Court of Appeals for the Second Circuit noted that "where 'a court is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than [to] leave the problem to foreign countries.'"[235] In applying this standard, courts have examined: "(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens."[236]

In examining these factors, the courts have applied the "conduct test" and the "effects test."[237] Under the conduct

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[232] Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2008).

[233] Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(17) (2006).

[234] SEC v. Berger, 322 F.3d 187, 192 (2d Cir. 2003).

[235] *Id.* (citing Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir. 1975)).

[236] *Berger*, 322 F.3d at 192-93 (citing Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London, 147 F.3d 118, 125 (2d Cir. 1998); Itoba Ltd. v. Lep Group PLC, 54 F.3d 118, 121-22 (2d Cir. 1995); Psimenos v. E.F. Hutton & Co., Inc., 722 F.2d 1041, 1045 (2d Cir. 1983)).

[237] *Berger*, 322 F.3d at 193.

test, jurisdiction exists when "substantial acts in furtherance of the fraud were committed within the United States.[238] That test is met when:

(1) "the defendant's activities in the United States were more than 'merely preparatory' to a securities fraud conducted elsewhere" and

(2) the "activities or culpable failures to act within the United States 'directly caused' the claimed losses."[239]

The effects test is "based on fraud which takes place abroad which impacts on 'stock registered and listed on [an American] national securities exchange and [is] detrimental to the interests of American investors.'"[240]

One example of the extraterritorial application of the U.S. insider trading laws is *SEC v. Rahim*.[241] On May 11, 2007, the SEC filed a complaint in the United States District Court for the Northern District of Illinois (Chicago) alleging that Hafiz Naseem, a junior investment banker at Credit Suisse Securities USA in New York "misappropriated confidential information concerning at least nine pending merger agreements" by tipping at least Ajaz Rahim, an investment banker in Pakistan, in advance of a public merger announcement by TXU Corp.[242]

Another example involves the activities of four Hong Kong residents in connection with News Corp.'s acquisition of Dow Jones in 2007.[243] On May 8, 2007, the SEC filed a

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[238] *Id.*

[239] *Id.*

[240] *Itoba*, 54 F.3d at 124.

[241] SEC v. Rahim, No. 1:07cv1208 (N.D. Ill. filed May 11, 2007).

[242] Third Amended Complaint at 1, SEC v. Rahim, No. 1:07cv1208 (N.D. Ill. filed May 11, 2007).

[243] Litig. Release No. 20447, SEC, SEC Settles $24 million Insider Trading Case Against Four Hong Kong Residents Including David Li Kwok Po, a Former Board Member of Dow Jones (Feb. 5, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20447.htm; Richard Pérez-Peña, *S.E.C. Fines 4 for Trades Involving Dow Jones*, N.Y. TIMES,

complaint in New York federal court alleging that David Li, a member of the Dow Jones board of directors, tipped his friend, Michael Leung, a co-passenger on a flight from Hong Kong to Shanghai, about News Corp.'s impending buyout offer.[244] Leung subsequently told his daughter and son-in-law.[245] Together, the three of them purchased approximately $15 million worth of Dow Jones stock in the weeks before News Corp.'s announcement.[246] After the announcement, the three sold their shares and made over $8 million in profit.[247] All four agreed to settle the SEC's claims, with David Li paying an $8.1 million civil penalty, Michael Leung paying $8.1 million in disgorgement and an $8.1 million civil penalty, and K.K. Wong (Leung's son-in-law) paying $40,000 plus interest in disgorgement and a $40,000 civil penalty.[248]

As the following examples illustrate, the conditions of the conduct and effects test may be easily met in global capital markets. Most hedge funds should therefore adopt, as a general view, the presumption that their traders activity will not escape the long reach of U.S. jurisdiction.

B. The Market Abuse Directive

With its core provisions limited to only three pages, the Market Abuse Directive is lucidly and elegantly drafted. Nevertheless, it represents a comprehensive system of rules for regulating insider trading (and market manipulation). It is, in this regard, all the more interesting, because it is, with a few notable exceptions, strikingly similar to the U.S. securities laws relating to this area of regulation. By reading the Market Abuse Directive, a lawyer or compliance officer familiar with the U.S. securities laws can obtain not only a rapid comprehension of the European insider trading regime,

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Feb. 6, 2008, *available at* http://www.nytimes.com/ 2008/02/06/business/media/06dow.html.

[244] Pérez-Peña, *supra* note 243.

[245] *Id.*

[246] *Id.*

[247] *Id.*

[248] *Id.*

but an insightful overview into the essential features of U.S. laws relating to insider trading. Traders can easily derive from the Market Abuse Directive a good, basic understanding of insider trading laws.

In other words, the Market Abuse Directive is well-suited to the compliance needs of hedge funds, helping to show the big picture that can be obscured by the many details of the U.S. insider trading laws. A synopsis of the key provisions of the Market Abuse Directive, highlighting the extent of its comparability with the U.S. insider trading laws, is therefore a fitting way to sum up the previous discussion and end this Article.

1. Restriction on Selective Disclosure

The Market Abuse Directive reflects the principle idea behind the SEC's Regulation FD. That is, prevention and control of selective disclosure by issuers and their representatives reduces the possibilities for insider trading at their source. Article 6(3) of the Market Abuse Directive is substantively the same as Rule 100 of Regulation FD, except that it requires public disclosure of inside information that was divulged to any person, not just certain securities market professionals and holders of the issuer's securities.[249] Like Regulation FD, it provides that this requirement does not apply if the person receiving the information owes a duty of confidentiality.[250] The Market Abuse Directive adds a prophylactic enforcement feature that Regulation FD does not have. It requires that issuers, or persons acting on their behalf or for their account, draw up a list of those persons working for them who have access to inside information.[251]

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[249] *Market Abuse Directive*, *supra* note 11, at art. 6(3). The Market Abuse Directive is also broader than Regulation FD in that it is not restricted to circumstances outside of the context of a contemplated public offering by an issuer. However, it does not prevent Member States from applying their constitutional rules relating to freedom of the press.

[250] *Id.*

[251] *Id.*

2. The Materiality Element

a. Present Disclosure of Price Sensitive Information

However, the Market Abuse Directive goes further than the U.S. securities laws, diminishing the prospects of insider trading by imposing affirmative requirements for present disclosure from issuers, as well as restrictions on selective disclosure to outsiders. Specifically, Article 6(1) of the Market Abuse Directive obligates issuers to inform the public, as soon as possible, of inside information.[252] The issuer may only delay public disclosure of inside information if such omission would not be likely to mislead the public and the confidentiality of that information is ensured.[253]

This principle of present disclosure differs from that of periodic disclosure under the U.S. securities laws. Whereas U.S. stock exchange rules mandate prompt disclosure of material new developments,[254] the U.S. securities laws do not impose any general affirmative duty to disclose.[255] The SEC was given authority under Section 409 of the Sarbanes Oxley Act to require present disclosure, but it has chosen to use this authority only to selectively augment the list of specific events that must be currently reported on Form 8-K.[256]

A present disclosure regime is not viable if you assume that the definition of materiality will not alter in the context of present disclosure as compared to that of periodic

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[252] *Id.* at art. 6(1).

[253] *Id.* at art. 6(2).

[254] *See, e.g.*, NYSE Listed Company Manual § 202.05.

[255] Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5."); Walker v. Action Indus. Inc., 802 F.2d 703, 706 (4th Cir. 1986) ("In order for there to be liability under 10b-5 for omissions or nondisclosure, however, a 'duty to speak' must exist.").

[256] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 33-8400, Exchange Act Release No. 34-49424, 69 Fed. Reg. 15594 (Mar. 25, 2004).

reporting and offering documentation.[257] As regards prospectus, annual, and quarterly reporting, materiality judgments err on the side of disclosure, because issuers are able to provide it and specifically required by extensive rules to do so. Indeed, even in the setting of a private placement when such rules do not strictly apply, it is market practice to generally observe them and include in the offering memorandum the same type and extent of disclosure as in a prospectus. In contrast, since present disclosure to this extent truly is unfeasible, it implies a variable definition of materiality, distinguishing between truly important information to be promptly communicated and less relevant information to be periodically communicated. At first thought, such a distinction is objectionable, because information either is or is not relevant to, and therefore needed by, investors. At a minimum, it introduces further complexity and uncertainty in the definition of materiality. The distinction could lead to a weakening of the sense of materiality as a heightened level of significance is, out of necessity, used to determine present disclosure.

In light of these drawbacks, the SEC generally prefers a system of periodic disclosure, subject to certain exceptions for current reporting.[258] Why then has Committee of European Securities Regulators ("CESR") not taken the same view as the SEC?

The present disclosure provision of the Directive can, in part, be explained as a quirk of history attributable to the absence of European or member state regimes for mandatory periodic reporting at the time of the Directive's adoption. Whereas the Market Abuse Directive was issued shortly after the Prospectus Directive at the end of 2003 and required to be transposed in member state law in October 2004, the Transparency Directive establishing a periodic reporting system was only issued in December 2004 and

[257] *See, e.g.*, *Basic*, 485 U.S. at 240 n.18 ("We find no authority in the statute, the legislative history, or our previous decisions for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited.").

[258] 17 C.F.R. § 249.308.

required to be transposed by January 2007.[259] Ironically, the Europeans repeated what Americans regard as an accident or mistake of history; that is, the passage of two separate statutes for offering disclosure and ongoing reporting rather than one integrated disclosure system.[260] In this regard, the Prospectus Directive is like the Securities Act and the Transparency Directive is like the Exchange Act. The present disclosure provision in the Market Abuse Directive filled the gap between the two.

Nevertheless, as suggested above, the Market Abuse Directive's present disclosure provision can also be explained by the distinction between materiality under it and under the Prospectus Directive. The definition of the materiality element in the Market Abuse Directive, which is incorporated by reference in the Transparency Directive, speaks of information of a precise nature that, if it were made public, would be likely to have a significant effect on the prices of the issuer's financial instruments that are admitted to trading on a regulated securities market in an EU member state.[261] The materiality element is defined differently under the Prospectus Directive as all information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to its securities.[262]

The required annual reports under the U.S. regime for periodic disclosure essentially amount to ongoing updates of the issuer's initial prospectus for going public,[263] but the annual reports under the Transparency Directive require significantly less disclosure than a prospectus under the Prospectus Directive. Thus, the notion of materiality under the Market Abuse Directive and the Transparency Directive is, in theory, less demanding of disclosure than that of the Prospectus Directive or the U.S. securities laws. Hedge

[259] Council Directive 2004/109, 2004 O.J. (L390) 38 (EC).

[260] *See supra* Part II.F.3.d.

[261] *Market Abuse Directive*, *supra* note 11, at art. 1(1).

[262] Directive 2003/71, art. 5(1), 2003 O.J. (L345) 64, 72 (EC).

[263] *See* 17 C.F.R. §§ 249.220f, 240.12b-20 (2008).

funds might, in theory, be able to trade in Europe on the basis of non-public information that is considered material under the U.S. securities laws, but not under the Market Abuse Directive.

In practice, this potential loophole is unlikely to be meaningful. The possible difference between the definition of materiality under the U.S. insider trading laws and the Market Abuse Directive is decreased by Directive 2003/124/EC implementing the Market Abuse Directive. In this implementing directive, the CESR hedged its bets by supplementing the Market Abuse Directive's standard of price sensitive information with the U.S. definition of materiality. Thus, Article 1(2) of the implementing directive stipulates that "'information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments . . . ' shall mean information a reasonable investor would be likely to use as part of the basis of his investment decisions."[264]

This definition of materiality could be interpreted differently under the Market Abuse Directive and the U.S. securities laws, even though their terms are substantially the same. The implementing directive presents it as an elaboration on the price sensitivity standard. Therefore, unlike the U.S. definition of materiality, it arguably should not be construed to broadly encompass the full disclosure that issuers give in their offering documents and periodic reports. This view is reinforced by the observation that the Directive's present disclosure regime would not be workable with an expansive definition of materiality.

However, the better perspective is that European and U.S. law are consistent in their notion of materiality. Under both, the meaning of materiality depends on whether the context concerns present or periodic reporting and an issuer or an outsider, though neither European nor U.S. law explicitly make these distinctions. Just as the pressure for transparency has led in the United States to the integration

[264] Commission Directive 2003/124, art. 5, 2003 O.J. (L 339) 70 (EC). [hereinafter *Directive Relating to Definitions*].

of disclosure under the Securities Act and Exchange Act, it will compel European regulators and issuers to favor the broad understanding of materiality and full disclosure that is contemplated by the Prospectus Directive. This context of materiality should be differentiated from that of present disclosure and insider trading.

As any securities lawyer with experience in counseling U.S. public companies knows, issuers are, in reality, confronted with the need to distinguish (i) highly important information that should be promptly disclosed in a press release and Form 8-K, and (ii) potentially material information that need merely be disclosed somewhere in the next periodic report, such as a regular earnings release, annual report on Form 10-K or quarterly report on Form 10-Q. The Market Abuse Directive explicitly expresses in its price sensitive standard what is arguably implicit in the way that U.S. securities lawyers make this distinction for purposes of advising issuers on present disclosure and outsiders on insider trading.[265]

Both in U.S. case law and practice, materiality determinations in the insider trading context appear to focus on price sensitivity. They tend, in their implementation, to differ from materiality determinations in an offering, periodic reporting or other context, even though the same definition of materiality is in principle applied. This ostensible contradiction is resolved by the U.S. courts' emphasis that materiality judgments depend on the facts and circumstances, meaning the same definition may apply differently in different situations. In addition, the occurrence of insider trading, and damages from it, are typically evidenced by the difference in the price of the relevant securities before and after revelation of the inside information. While issues of this evidence and of materiality are technically distinct, they will, as a practical matter, usually blur together.

Thus, in determining whether inside information is material from an insider trading perspective, its price

[265] Directive 2003/71, art. 5(1), 2003 O.J. (L345) 64, 72 (EC).

sensitivity, rather than the need for its disclosure in a periodic report, is at the center of the U.S. as well as European analysis. As a practical matter, to arrive at sensible U.S. judgments relating to the materiality of inside information, compliance personnel at hedge funds are likely to find that the more effective approach is to first ask whether revelation of the information would have a significant impact on the price of the issuer's securities. In particular, compliance personnel can involve traders in replying to their own materiality questions by having them respond to this business question of impact on price, which they should be well-qualified to answer. The alternative approach for compliance personnel would be to consider on the basis of their legal experience whether they would have published the information in a periodic report or prospectus if they were the issuer. This alternative approach is likely to be less useful for yielding practical answers.

Second, the periodic disclosure of an issuer is relevant, because it may provide some indication of possible immateriality. As noted above in Part III, a hedge fund with inside information may be more or less comfortable about its immateriality depending on when the issuer last published a periodic report or press release. On the one hand, omission of inside information from a recent report could suggest it is immaterial. On the other hand, the inside information may await publication as material new information if the latest report is not recent and the disclosure in it possibly out of date.

Similar analysis is pertinent in the context of the European present disclosure regime, but another possible indicator of immateriality comes to the fore. Because of the practical limitations on real time disclosure, delay can still explain why material, inside information has not been disclosed by the issuer. However, this circumstance is less likely to be the explanation than in the U.S. periodic reporting system. Under the European regime, a hedge fund could more readily conclude from a failure of an issuer to disclose inside information that it is immaterial, except that this failure could mean that the issuer is striving to keep

such information confidential for a legitimate purpose. If it does so, it qualifies for an explicit exception from its present disclosure obligation, provided that delay of disclosure would not be likely to mislead the public.[266]

Confidentiality is also a significant consideration in the U.S. analysis of the issuer's public disclosure, though not to the same extent as in the European analysis. It is not a general, explicit exception to periodic disclosure obligations under the U.S. securities laws. However, it affects whether an issuer may refrain from public disclosure under Regulation FD. Moreover, it may be the reason why information has not been disclosed in a periodic report, since issuers will otherwise usually provide all material information in such a report even though certain specified types of information are all that is required to be reported.[267] In addition, when U.S. issuers want to keep information confidential, they will more readily seek to take the position that its disclosure is not ripe; that is, the information is not certain enough to qualify as material when the measure of it takes into account the probability component of the expected value test for materiality (i.e., the probability of an occurrence multiplied by its magnitude). As discussed

[266] *Market Abuse Directive*, *supra* note 11, at art. 6(2). In particular, as provided in one of the implementing directives to the Market Abuse Directive, an issuer may have a legitimate interest in keeping information confidential and delaying public disclosure in certain, specified non-exhaustive circumstances, including negotiations in cases where the outcome or normal pattern of the negotiations would be likely to be affected by public disclosure. *Directive Relating to Definitions*, *supra* note 264, at art. 3(1). Under art. 3(2) of this implementing directive, an issuer must satisfy certain requirements to ensure the confidentiality of inside information.

[267] Rule 12b-20 under the Exchange Act will tend to compel issuers to disclose all material information, whether or not demanded by a specific disclosure rule. 17 C.F.R. § 240.12b-20 (2008). This rule provides that: "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." § 240.12b-20.

immediately below, the Market Abuse Directive highlights this issue with its concept of precise information.

b. Information of a Precise Nature

If information does not have a precise nature, then it does not fall within the Market Abuse Directive's definition of inside information and its prohibition on insider trading.[268] The concept of precise nature is employed to exclude from the ambit of this prohibition market rumors and indefinite information, not ripe for disclosure. These exclusions may be, and are in practice, derived from principles of U.S. insider trading law. However, they are not directly addressed by it. Indeed, compliance personnel at hedge funds may find it more intuitive and practical to evaluate the certainty and quality of inside information by working back from the Directive's definition of precise nature than by attempting to derive results from U.S. principles.

Information is deemed to be of a precise nature if:

- it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so; and

- if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments.[269]

CESR guidance emphasizes that "the precise nature of information is to be assessed on a case-by-case basis."[270] However, it observes that an important factor to consider is

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[268] *See Market Abuse Directive*, *supra* note 11, at art. 1(1).

[269] *See Directive Relating to Definitions*, *supra* note 264, at art. 1(1).

[270] Market Abuse Directive: Level 3—Second set of CESR Guidance and Information on the Common Operation of the Directive to the Market, CESR/06—5626, July 2007, at cl. 1.5 [hereinafter *Market Abuse Directive: Level 3*].

whether there is firm and objective evidence for a set of circumstances as opposed to rumors or speculation.[271] It also points out that the ex ante information available at the time is the appropriate basis for appraising judgments about what may reasonably be expected.[272]

As regards the criterion of specificity, the CESR guidance cites two considerations. Information qualifies as specific if the reasonable investor is able to determine with confidence how the information, once publicly known, would affect the price of the relevant financial instrument.[273] Information also meets the specificity test if "it is likely to be exploited immediately on the market"; that is, "as soon as the information became known, market participants would trade on the basis of it."[274]

c. Conclusion

The upshot of the foregoing is the conclusion that, practically speaking, materiality analysis is not greatly different under the Market Abuse Directive than U.S. insider trading laws, though comparison of the two casts light on what this analysis entails.

3. Inside Information

The Market Abuse Directive, like this Article, uses the term "inside information" instead of "non-public information."[275] This Article regards the term "inside information" as more accurate from a U.S. perspective, because not even the SEC takes the position that all

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[271] *See id.*

[272] *See id.*; *Directive Relating to Definitions*, *supra* note 264, at whereas cl. (1).

[273] *See Market Abuse Directive: Level 3*, *supra* note 270, at cl. 1.8. The CESR guidance provides the following example: "[S]omeone knowing that a particular issuer was about to be subject to a takeover bid could be confident that that issuer's price would rise when the bid became public." *Id.*

[274] *Id.*

[275] *See Market Abuse Directive*, *supra* note 11.

material, non-public information is subject to the prohibition on insider trading. For example, under the mosaic theory, the SEC accepts that this prohibition does not apply to material, non-public information that is generated by compiling and analyzing bits of immaterial inside information.

Concerned that the SEC might extend the insider trading laws to almost all material, non-public information, the U.S. courts have sought, in the concept of a duty to disclose, to limit the application of the insider trading laws to illegitimate use of non-public information. Although the need and attempt to establish such a limit is understandable, the result is not wholly satisfactory and is the crux of the difficulties with the U.S. insider trading laws. Leaving open loopholes, U.S. theories of insider trading must be, and have been, amended, stretched, and contorted to punish conduct that the theories do not cover, but that the SEC and courts consider bad. In other words, what the U.S. courts say they are doing in insider trading cases:

> (i) does not completely align with what they actually do; and
>
> (ii) provides an unduly complex and obscure explanation of this alignment when it exists.

To defend a client, a litigator will be interested in using what the courts say the law is. However, when asking what the law is, a compliance person at a hedge fund is interested in predicting what the courts will do. Interestingly, with regard to the element of "insidedness" in U.S. insider trading law, this prediction can be obtained more easily, and in most instances just as reliably, from the Market Abuse Directive than the convoluted theories of fiduciary duty, misappropriation and tipping under the U.S. case law and the various regulatory adaptations to these theories. One would not ordinarily cite the Market Abuse Directive in a U.S. court, but one might utilize it to foresee the likely legal outcome. Indeed, considering that the loopholes and anomalies in U.S. insider trading law have usually been overcome by the SEC rather than rigorously respected by the

U.S. courts, true legal realists may wonder whether the Market Abuse Directive sets forth a better framework than U.S. jurisprudence for determining what conduct will and will not be punishable under the "insideness" element of U.S. insider trading law.

This "insideness" element of the Market Abuse Directive is found not in its definition of inside information, but rather in the way this definition is deployed. Under Article 1(1) of the Market Abuse Directive, inside information is defined as non-public information.[276] Inside information and non-public information are coextensive in their application to insider trading by insiders. Thus, Article 2(1) of the Market Abuse Directive simply prohibits trading on the basis of inside information by any person who possesses that information by virtue of:

- his membership of the administrative, management or supervisory bodies of the issuer
- his holding in the capital of the issuer; or
- his having access to the information through the exercise of his employment, profession or duties.[277]

Article 2 therefore represents the equivalent of the classical theory of insider trading under U.S. law, which now characterizes the foregoing persons as constructive fiduciaries and covers trading by them without complication or difficulty.[278] It is the question of trading by persons other

[276] *See Market Abuse Directive*, *supra* note 11, at art. 1(1).

[277] *See id.* at art. 2(1). It also prohibits trading on inside information by a person who possesses that information by virtue of his criminal activities. For example, a terrorist might engage in short selling in anticipation of a market downturn after a planned terrorist attack.

[278] One notable difference is the absence of a scienter requirement under the Market Abuse Directive. With respect to its Article 2 and insiders in possession of inside information, no intent to defraud, recklessness or negligence must be shown. With respect to its Article 4 regarding outsiders, the standard is "what a normal and reasonable person would know or should have known in the circumstances." *Market*

than these insiders that is the source of the problems and complexities of the U.S. insider trading laws.

In its application to insider trading by outsiders, inside information under the Market Abuse Directive is a more limited notion than non-public information. If it cannot be traced back to an improper disclosure by an insider, non-public information is not inside information. Thus, Article 3 restricts tipping by forbidding an insider from:

- disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;

- recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[279]

Closing off any potential loophole created by the exception in the first prong of this provision, Article 6(3) prevents a person from making selective, non-confidential disclosure to a third party in the normal course of the exercise of his employment, profession or duties.[280]

Under Article 4, Articles 2 and 3 also apply to any person other than the persons referred to in those Articles (i.e., insiders and their accomplices) who possesses inside information while that person knows or ought to have known that it is inside information.[281] Literally and technically, Article 4 could be read to say a tippee or other person under it should know that information is inside information if he

Abuse Directive, *supra* note 11, at whereas cl. (18). More demanding of care than a scienter standard, this standard is expressed in the terms of a negligence construct. In contrast, a scienter requirement is applicable in the United States to actions under Rule 10b-5. *See supra* Part II.A. Its absence, however, is unlikely to be a significant distinguishing factor between U.S. insider trading law and the Market Abuse Directive, because it is generally easy to show that a fiduciary knew he was trading illegally on inside information. *See supra* Part II.C.

[279] *Market Abuse Directive, supra* note 11, at art. 3.

[280] *Id.* at art. 6(3).

[281] *Id.* at art. 4.

should know it is non-public. This reading seems possible, because inside information is defined as information of a precise nature which has not been made public.

However, within the structure of the statute as a whole and in light of the meaning of precise information, a better interpretation of Article 4 is that its inside condition is only met if an outsider should have reasonably inferred that insiders inadvertently or improperly leaked non-public information. In particular, as explained above, the concept of precise information excludes rumor, speculation and non-specific information from the prohibition on insider trading.

Furthermore, although the Market Abuse Directive does not explicitly admit the permitted use of immaterial inside information under the mosaic theory, it can be interpreted to implicitly allow it. It does not restrict disclosure of immaterial inside information (as opposed to material inside information) and acknowledges the role of research analysts. It states that: "Research and estimates developed from publicly available data should not be regarded as inside information."[282]

The structure of the statute is such that material information will ordinarily be disclosed by an issuer under the Market Abuse Directive's present and selective disclosure provisions unless it is confidential. The best indication of inside information will therefore be reasons or circumstances suggesting the information was intended to be kept confidential. Thus, the Market Abuse Directive and the U.S. insider trading laws dovetail in their focus on a duty of confidentiality, except that the Market Abuse Directive is not burdened with an esoteric agency theory determining how this duty is passed from one person to another.

Like Moliere's bourgeois gentilhomme[283] learning from his poetry teacher that he has been speaking prose his whole life, U.S. securities lawyers may be delighted to discover that the simple and lucid provisions of Articles 3 and 4 of the

[282] *Market Abuse Directive*, *supra* note 11, at whereas cl. (31).

[283] JEAN-BAPTISTE POQUELIN (MOLIERE), LE BOURGEOIS GENTILHOMME (1670).

Market Abuse Directive effectively codify the misappropriation theory, the tippee theory, Rule 14e-3, Rule 10b5-1, Rule 10b5-2, and other miscellany of U.S. insider trading law. The only things left out of it are the potential loopholes under U.S. law, which traders would be ill-advised to count on.

4. Non-Corporate Inside Information

As explored above in Part II.F.2.b, the U.S. theories of insider trading are unclear and indirect in their extension to insider trading on the basis of non-public information that is not corporate inside information. An example is trading by persons that know in advance about upcoming recommendations of securities commentators to be published in influential analyst reports or the press. In the Market Abuse Directive's definition of inside information, this issue of non-corporate inside information is addressed by language about information relating *indirectly* to one or more issuers of financial instruments.[284] CESR guidance explains that this language is intended to prohibit insider trading on the basis of such information as:

- the coming publication of rating agencies' reports;
- the coming publication of research, recommendation or suggestions concerning the value of listed financial instruments; or
- central bank decisions concerning interest rates.[285]

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[284] *Market Abuse Directive*, *supra* note 11, at art. 1.

[285] Market Abuse Directive: Level 3—second set of CESR guidance and information on the common operation of the Directive to the market (July 2007), at cl. 1.6. Following are the other examples of non-corporate inside information cited in it:

> • Data and statistics published by public institutions disseminating statistics; . . .
> • Government's decisions concerning taxation, industry regulation, debt management, etc.;

5. Applicability to Debt and Derivative Securities

Whereas the extension of the U.S. insider trading laws to debt and certain derivative securities is uncertain, there is no doubt that the Market Abuse Directive applies to all forms of securities, including:

- transferable securities,[286]

> • Decisions concerning changes in the governance rules of market indices, and especially as regards their composition;
> • Regulated and unregulated markets' decisions concerning rules governing the markets;
> • Competition and market authorities decisions concerning listed companies;
> • Relevant orders by government bodies, regional or local authorities or other public organizations;
> • A change in trading mode (e.g., information relating to knowledge that an issuer's financial instruments will be traded in another market segment: e.g. change from continuous trading to auction trading); a change of market maker or dealing conditions.

Id. at cl. 1.16.

[286] Specifically, the Market Abuse Directive applies to transferable securities as defined in Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field. This definition, at Annex § C, states that transferable securities comprise:

> • Shares or certificates representing an ownership interest in a company, and depository receipts in respect of shares;
> • Bonds or other debt securities whether or not convertible into shares;
> • Securities normally dealt in on the money market (such as certificates of deposit, euro-commercial paper);
> • Units in collective investment schemes;
> • Warrants or similar securities entitling the holder to acquire any of the above securities or any basket of such securities or to receive a cash amount determined by reference to a future price or value of any such security or basket.

- units in collective investment undertakings,
- money market instruments,
- financial-futures contracts, including equivalent cash-settled instruments,
- forward interest-rate agreements,
- interest-rate, currency and equity swaps,
- options on currency and interest rates, as well as other options to acquire or dispose of any instruments falling into these categories, including equivalent, cash settled instruments, and
- derivatives on commodities.[287]

Recognizing that a variety of authorities with different responsibilities may create confusion, the Directive requires each Member State to designate a single administrative authority competent to ensure compliance with its provisions.[288] This stands in contrast with the "alphabet soup" of regulators of different financial instruments in the United States.

However, the Market Abuse Directive does contain potential loopholes in that it only covers financial instruments admitted, or requested to be admitted, to trading on a regulated market in a member state.[289] Not all securities markets in Europe qualify as regulated markets. For example, AIM and the Euro MTF Market of the LuxSE do not. In addition, the scope of the Market Abuse Directive does not extend to trading in Europe of securities listed on U.S. and other non-European exchanges, which also do not

[287] *Market Abuse Directive*, *supra* note 11, at art. 1(3). A catch-all provision covers any other instrument, subject to the limitations described.

[288] *Id.* at art. 11 and whereas cl. (16).

[289] *Id.* at art. 9.

fall within the definition of a regulated market.[290] Moreover, unlisted securities, whether European or non-European, are outside of the Market Abuse Directive's ambit.

On the other hand, these potential loopholes are not as large as they may appear. Local insider trading laws may apply when the Market Abuse Directive does not. For example, both AIM and the Euro MTF Market of the LuxSE impose the Market Abuse Directive's restrictions on insider trading.[291] Unlike in the United States, debt securities in Europe are commonly listed on securities exchanges, which may be regulated markets or, like in Luxembourg, may be subject to insider trading regulations.

Trading in derivative securities will often be regulated by the Market Abuse Directive because it applies to any financial instrument "not admitted to trading on a regulated market in a Member State but whose value depends on a financial instrument so admitted or requested to be so admitted."[292] If a debt or derivative security is covered by the Market Abuse Directive, then trading in it is subject to the Directive, irrespective of whether or not the transaction itself actually takes place on a regulated market.[293] Thus, the Market Abuse Directive contains provisions on derivative securities that are similar to Section 20(d) of the Exchange Act. However, unlike Section 20(d), the Directive's provisions are not arbitrarily limited to certain forms of derivative securities depending on who regulates them or whether they technically qualify as securities.

For anyone trading debt or derivative securities in the United States, their inclusion in the Market Abuse Directive

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[290] *Id.* at art. 1(4) (citing Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, at art. 1(13)).

[291] Tobias H. Troger, *Corporate Governance in a Viable Market for Secondary Listings*, 10 U. PA. J. BUS. & EMP. L. 89, 156-57 (2007); The Luxembourg law of 9 May 2006 on market abuse (implementing Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)).

[292] *Market Abuse Directive*, *supra* note 11, at art. 9.

[293] *Id.* at whereas cls. (2) and (24) (discussing the need for market integrity).

should be taken as a warning about the potential applicability of U.S. insider trading laws to such securities. Inspired by the U.S. insider trading laws, many regulators and nations in Europe reached the consensus that such securities *should* be subject to the insider trading laws. In light of the success of the U.S. capital markets, the Europeans apparently concluded that such restrictions on insider trading were essential to the health of the financial markets, especially the need for confidence in their integrity.[294]

This consensus is all the more striking because France, Germany, England, and other European Union countries were not prone to regulating insider trading. Historically, in European nations, insider trading laws, if they existed at all, were rarely, if ever, enforced.[295] In particular, England had reason to be inclined to reject unnecessary regulation, because it has emphasized a light touch approach in its successful efforts to attract business to London instead of New York.[296] The Financial Services Authority ("FSA") stresses that it is not an "enforcement led" regulator.[297] In its marketing to foreign issuers, the London Stock Exchange ("LSE") underlines the negatives of U.S. overregulation

[294] *Id.* at whereas cls. (2) and (24).

[295] Marc I. Steinberg, *Insider Trading: A Comparative Perspective*, 3 CURRENT DEVS. IN MONETARY & FIN. L. 831, 843 (2005).

[296] COMM. ON CAPITAL MKTS. REGULATION, Interim Report of the Committee on Capital Markets Regulation (2006); Heather Timmons, *New York Isn't the World's Undisputed Financial Capital*, N.Y. TIMES, Oct. 27, 2006, at C1, *available at* http://www.nytimes.com/2006/10/27/business/worldbusiness/27london.html (noting that "London is attracting investors and companies because of a perception that regulatory scrutiny is more burdensome in the United States than in London"); Jenny Anderson, *About Those Fears of Wall Street's Decline*, N.Y. TIMES, Jan. 26, 2007, at C6, *available at* http://www.nytimes.com/2007/01/26/business/26insider.html (discussing the lack of regulation in London); Patrick McGeehan, *In Dueling Financial Studies, Fuel for New York-London Rivalry*, N.Y. TIMES, Mar. 19, 2007, at B2, *available at* http://www.nytimes.com/2007/03/19/nyregion/19cities.html.

[297] Sally Dewlar, Dir. of Mkts. Div., Address at the Market Abuse Seminar 3 (May 22, 2007), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0522_sd.shtml.

under Sarbanes Oxley relating to NYSE and NASDAQ listing, and the absence of them relating to LSE listings.

The Market Abuse Directive would, at best, be considered persuasive authority in U.S. courts and might, at worst, be actively ignored as foreign law by the U.S. Supreme Court.[298] However, the European application of the Market Abuse Directive to trading in debt and derivative securities is a strong indicator that the SEC, a like-minded regulator, probably shares the view that such trading should be regulated by the insider trading laws. As shown in Part II, when the SEC believes that conduct should be punished by the U.S. insider trading laws, the conduct usually will be sanctioned even if it might appear to be allowed by black letter law. Furthermore, the applicability of U.S. insider trading laws to options, but (possibly) not to certain other derivatives or debt securities in certain circumstances, was shown to be anomalous. The provisions of the Market Abuse Directive lend support to the view that the SEC is unlikely to accept this anomaly as justifiable. In particular, the *Barclays* case appears to not just be relevant to the trading of debt securities in the pre-bankruptcy context, but rather to be a harbinger of the future applicability of the U.S. insider trading laws to debt securities in general.

6. Enforcement

As noted at the beginning of this Section, hedge funds may encounter situations where, instead of or in addition to the U.S. insider trading laws, the Market Abuse Directive applies to their trading, such as in debt or derivative securities. In the example of CDSs described above in Part II.H, the FSA as well as the SEC, was involved in the investigation of the alleged insider trading.

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[298] *See* Adam Liptak, *U.S. Court, a Longtime Beacon, is Now Guiding Fewer Nations*, N.Y. TIMES, Sept. 18, 2008, at A1, *available at* http://www.nytimes.com/2008/09/18/us/18legal.html (discussing the "adamant opposition" of some Supreme Court justices to the citation of foreign law).

Enforcement of the Market Abuse Directive may encompass local or extraterritorial trading. Article 10 of the Market Abuse Directive gives a member state jurisdiction over actions carried out in its territory or abroad concerning financial instruments that are admitted, or requested to be admitted, to trading on a regulated market situated or operating within its territory.[299] Article 10 also provides that the Market Abuse Directive shall be applied by a member state to actions carried out in its territory concerning financial instruments admitted, or requested to be admitted, to trading in another member state.[300] Thus, the Market Abuse Directive may be enforced against the trading anywhere of securities listed anywhere in Europe on a regulated market, including shares of companies that are listed both in Europe and in the United States.[301]

The Market Abuse Directive is not, by its terms, applicable to trading in a member state of unlisted securities, or securities listed only in the United States or another non-European country. However, as suggested above, local insider trading laws may fill in these gaps.

Article 6(9), of the Market Abuse Directive may prompt a European regulator to investigate an insider trading matter, or refer it to the SEC, even if the matter is ultimately found to be outside of the Market Abuse Directive's jurisdiction.[302]

This provision and others regarding enforcement of the Market Abuse Directive, such as Article 9 regarding jurisdiction and Article 6(3), regarding insider lists, signify that insider trading rules in Europe are not a possible opportunity for U.S. hedge funds, but rather a risk. In particular, these rules contain significantly fewer loopholes than the U.S. insider trading laws.

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[299] *Market Abuse Directive*, *supra* note 11, at art. 10.

[300] *Id.*

[301] Note, however, that in theory a court might decide that it has competence or subject matter jurisdiction over a matter regarding the Market Abuse Directive, but also that it lacks personal jurisdiction over the defendant or is an inconvenient forum.

[302] *Market Abuse Directive*, *supra* note 11, at art. 6(9).

However, limited enforcement of European insider trading rules, as opposed to the rules themselves, may give a hedge fund some leeway in certain situations. While prominent in the United States, enforcement of insider trading laws by private plaintiffs has been rare in Europe for a variety of reasons, such as limits on class action suits. Furthermore, European regulators have historically been less effective and active than the SEC in enforcing the insider trading laws.[303] This said, there appears to be a trend towards more active enforcement of the insider trading laws in Europe.[304]

VI. EPILOGUE

At the time this Article went to press, the SEC charged a hedge fund manager in the "first insider trading enforcement action involving credit default swaps."[305] This case may represent the next step in the recent, but foreseeable, expansion of the insider trading laws outside of the traditional domain of equity securities. It further signifies that the SEC continues to focus on bringing insider trading actions against hedge funds and, as past history teaches, will not be deterred by legal or practical uncertainties in extending insider trading enforcement to new areas like CDSs.

[303] Troger, *supra* note 291, at 87-88.

[304] *See* Dewar, *supra* note 171; David Jolly, *Another Former Executive Detained in EADS Insider Trading Investigation*, INT'L HERALD TRIB., June 17, 2008, at Fin.16.

[305] Press Release, SEC, *SEC Charges Hedgge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps* (May 5, 2009).