Michigan Journal of International Law

Volume 9 | Issue 1

1988

The Regulation of Insider Trading in the United States, United Kingdom, and Japan

Barbara Ann Banoff
University of Louisville

The Regulation of Insider Trading in the United States, United Kingdom, and Japan

Barbara Ann Banoff*

Insider trading has long been the subject of intense debate (and, more recently, intensive enforcement activity) in the United States.

Those arguing that insider trading should be prohibited state that it destroys investor confidence in the stock market[1] and harms those who trade with, or on the other side of the market from, the insider.[2] Opponents of insider trading also make two related, but somewhat mutually exclusive, arguments: first, that insider trading delays the release of information both to the public and within the corporation, thus harming both market and corporate efficiency,[3] and second, conversely, that it harms corporations by resulting in the premature release, through leakage, of their confidential information.[4] The final argument, and the clear winner in the political stakes at least, is that insider trading just isn't fair.[5]

Those who argue that insider trading should not be prohibited (and sometimes even that it should actively be encouraged) state that it provides entrepreneurial

* Harold Edward Harter Professor of Commercial Law, University of Louisville. B.A. 1966, Radcliffe College; J.D. 1973, University of Santa Clara.

I thank Professor John Farrar of the University of Canterbury, David Reid, Esq. of Allen & Overy, and Pamela Atkins of Buraff Publications, Inc., for their assistance in obtaining otherwise unavailable materials, and Susan Armstrong, J.D. 1988, University of Louisville Law School, for her research assistance.

1. D. LANGEVOORT, INSIDER TRADING HANDBOOK 12–13 (1987 ed.). *See also* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law*, 93 HARV. L. REV. 322, 353–56 (1979); Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985).

2. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). *See also* 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 (1981).

3. *See, e.g.*, R.C. CLARK, CORPORATE LAW § 8.2.3 (1986); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

4. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEG. STUD. 801, 814–15 (1980).

5. D. LANGEVOORT, *supra* note 1, at 13–14.

compensation and provides an incentive for management to take beneficial risks.[6] They also argue that it does not harm traders[7] and does not decrease confidence in the markets.[8] Indeed, they say, insider trading is an important mechanism of market efficiency.[9] Finally, since insider trading does not harm anyone and produces substantial benefits, it is not unfair.[10]

While the debate will undoubtedly continue, the trend in the United States is not only to continue the prohibition against insider trading, but also to expand its coverage and increase the penalties for violation.[11] The United States, however, is not the only country with a developed securities market, nor is it the only country in which insider trading is controversial.

The world's three major stock exchanges are located in New York, London, and Tokyo. In the United Kingdom, a decade of controversy led to the relatively recent enactment of a law making insider trading, at least in some circumstances, a criminal offense. In Japan, insider trading is theoretically illegal, but the law is not enforced and most observers believe that insider trading is quite common.

This article will discuss the laws regulating insider trading in the United States, the United Kingdom, and Japan. A comparative analysis is useful for two reasons.

First, securities markets are now transnational. American companies list their securities on foreign exchanges and foreign issuers' securities are traded here.[12] Foreign investors may trade on the American stock or options markets (and

6. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

7. *See, e.g.*, Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863 (1987).

8. *Id.* at 894–97.

9. Gilson & Kraakman, *The Mechanisms of Market Eficiency*, 70 VA. L. REV. 549 (1984). Gilson and Kraakman also argue that the efficiency of this mechanism would be improved if it were easier for the market to decode the identity of the trader. Accordingly, they propose a requirement of advance notification.

10. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323–39.

11. Two versions of a proposed amendment to the Insider Trading Sanctions Act of 1984 are currently before Congress. Both would codify the "misappropriation theory" discussed in the text accompanying notes 45–46, *infra*. One bill was proposed by an *ad hoc* group of securities lawyers (the "Pitt group"), 19 Sec. Reg. & L. Rep. (BNA) 903 (June 19, 1987); the other has been recommended by the SEC, *id.* at 1284 (Aug. 14, 1987), *modified id.* at 1817 (Nov. 27, 1987). Neither version requires that insider trading be labelled "fraud"; both focus simply on "wrongful" use. In fact, the principle drafter of the "Pitt group's" version recently stated that his bill rests on a "market unfairness" concept. 20 Fed. Sec. Reg. & L. Rep (BNA) 487 (Apr. 1, 1988).

There is, however, some doubt that either version will become law. Two SEC Commissioners oppose new legislation, and an SEC official has predicted that the odds are strongly against enactment, at least this year. *Id.* at 323 (Mar. 4, 1988).

12. For example, according to the SEC, there are 15 U.S. securities listed on the Tokyo Stock Exchange and 8 Japanese securities listed on the New York Stock Exchange, with another 18 Japanese securities quoted on NASDAQ. 18 Sec. Reg. & L. Rep. (BNA) 769 (May 30, 1986.)

sometimes may trade on inside information).[13] American investors may purchase securities in foreign markets and may even use foreign intermediaries to trade on American markets—a practice which occasionally has made the enforcement of our insider trading laws difficult.[14]

The effective enforcement of any prohibition of insider trading will therefore depend, at least at times, on bi-lateral or multi-lateral cooperation. That cooperation is more likely to be achieved if the other country or countries involved also prohibit insider trading.[15]

Second, to the extent the existence or scope of the prohibition differs from country to country, some useful light may be shed on the controversy over insider trading generally. Part of the difficulty for those who believe that insider trading should not be prohibited is that they must argue from suppositions in the absence of data; if (hypothetically) insider trading were not illegal, then a given result would or would not follow. Since, however, insider trading in the United States *is* illegal, the consequences of permitting it cannot be tested here. The availability of developed securities markets in countries where insider trading is not illegal, whether formally or merely functionally, provides a laboratory in which to test the arguments.[16]

Part I of this article will briefly discuss the American laws regulating insider trading;[17] Part II will discuss the law of the United Kingdom; and Part III will discuss the regulation—or, more accurately, the non-regulation—of insider trading in Japan.

13. *See, e.g.*, SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981).

14. For example, Dennis Levine used a Bahamian bank to make over $12.6 million in profits over a five-year period. G. Lynch & R. Souza, SEC Enforcement Developments October 1895 through September 1986 28 (Sept. 19, 1986) (unpublished manuscript), *presented at* Fourteenth Annual Securities Regulation Institute (U.C.S.D 1987).

15. Foreign bank secrecy and blocking laws have been a particular problem. In 1982, the United States and Swiss governments signed a Memorandum of Understanding (MOU) with respect to problems of insider trading. The MOU was accompanied by a private agreement among members of the Swiss Banker's Association who trade on U.S. securities markets. *See generally id.* at 69–70; Note, *Banking Secrecy and Insider Trading: The U.S.-Swiss Memorandum of Understanding on Insider Trading*, 23 VA. J. INT'L L. 605 (1983). The MOU and the private agreement were intended to assist U.S. authorities in obtaining information, and to a certain extent they have done so. Nevertheless, it is widely believed that cooperative efforts will be strengthened when insider trading becomes illegal in Switzerland—which is expected to happen in mid-1988. 1 Int'l Sec. Reg. Rep. No. 2 at 3 (Jan. 6, 1988).

16. I can do no more than suggest areas for empirical research. I hope that those engaged in such research will refine my suggestions.

17. The discussion must of necessity be brief. My purpose here is to furnish an intelligible summary for purposes of comparison. Readers will have to look elsewhere for a comprehensive discussion. Insider trading now has its own subheading in the *Index to Legal Periodicals*, and is the topic of an excellent one volume treatise by Professor Langevoort. I have not even attempted to cite all of the available articles; a comprehensive bibiography would run for several pages. I can only assure those who are not cited that they were at least read, and that their absence is not a comment on my view of their importance.

The article will conclude that there are enough similarities between the laws of the United States and the United Kingdom to make the prospects for multinational cooperation good. Indeed, such cooperation has already commenced.[18]

The Japanese situation is more ambiguous. The Japanese have signed an agreement to cooperate with the American regulatory agencies,[19] and their laws look somewhat like ours on paper. However, those laws are not enforced, and the Japanese stock markets have been described as "an insider's paradise."[20] Whether the Japanese will be more committed to assisting the United States to enforce its laws than they are to enforcing their own remains to be seen. That lack of enforcement, however makes the Japanese markets[21] a likely source of empirical evidence in the continuing debate over insider trading.

I. United States

The primary source for the regulation of insider trading in the United States is federal law. The law is enforced by a federal regulatory agency, the Securities Exchange Commission, by federal prosecutors, and by federal private civil rights of action, both express and implied. State law has played a relatively minor role.[22]

In the United States, it is unlawful for a corporate fiduciary to trade in the securities of his or her own company on the basis of material, non-public information.[23] Fiduciaries who may not trade may not "tip" for personal pecuniary benefit.[24]

Non-fiduciaries are also prohibited from trading or tipping under certain circumstances. First, "tippees" who know that their "tipper" breached a fiduciary duty in giving them the information may not trade on it or tip others.[25] Second, those who are given confidential information because of their professional or business relationship with the company—so-called "temporary insiders"—may not trade on or tip that information.[26] Third, those who misappropriate information in violation of a duty to an employer (who is not the issuer of the securities

18. *See infra* text accompanying notes 197–98.

19. *See infra* text accompanying notes 199–200.

20. Repeta, *Declining Public Ownership of Japanese Industry: A Case of Regulatory Failure?*, 17 Law In Japan 184, *cited in* Murofushi, The Regulation of Insider Trading in Japan 21 n. 28 (Dec. 15, 1987) (unpublished manuscript).

21. Of course, Japan is not the only country with no real restraints against insider trading. In fact, most of the members of the EEC do not yet prohibit it. *See generally* Note, *Insider Trading and the EEC: Harmonization of the Insider Trading Laws of the Member States*, 8 B.C. Int'l & Comp. L. Rev. 151 (1985).

22. D. Langevoort, *supra* note 1, at 22.

23. Chiarella v. United States, 445 U.S. 222 (1980). It should be noted that American law applies to closely held, as well as publicly traded, securities.

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

25. *Id.*

26. *Id.* at 655, n. 14.

traded) commit a crime if they trade or tip.[27] Finally, no one in possession of material, non-public information relating to a tender offer, who acquired that information from the bidder or target, may use it to trade, and insiders of the bidder and target may not disclose information to anyone likely to trade, whether or not they violate a fiduciary duty by doing so.[28]

As in other areas of securities regulation, the law of insider trading is in a process of evolution. However, subject to correction in the next Supreme Court term or Congressional session, the following sections summarize the applicable statutes and rules.

A. *Rule 10b-5*

Rule 10b-5[29] is a "catch-all" antifraud rule which the SEC promulgated in 1943 pursuant to its authority, under section 10(b) of the Securities Exchange Act of 1934,[30] to prohibit "any manipulative or deceptive device or contrivance."

While most cases brought under Rule 10b-5 involve misrepresentation,[31] the rule has also been stretched to cover conduct, such as insider trading, in which the complaint is not that someone lied, but that he or she did not say anything at all.

While Congress could have made insider trading unlawful without worrying about whether it was fraudulent, it has not yet done so.[32] Thus, the Commission and the courts could only reach insider trading by framing the prohibition in terms of disclosure.[33] They did so by announcing that insiders must either disclose or abstain from trading. If they trade without disclosing, they have committed fraud within the meaning of the rule.[34] Nevertheless, while formally denominated "fraud", the gravamen of an inside trading case is unjust enrichment, and the policy served is not disclosure but fairness.[35]

1. *Fiduciaries*

The early lower court cases applying Rule 10b-5 to insider trading rested, at least in part, on a theory of market egalitarianism; all traders in the market should have, or at least have access to, relatively equal information.[36]

27. Carpenter v. United States, No. 86–422, slip op. (U.S. Nov. 16, 1987).

28. *See* Rule 14e–3, 17 C.F.R. § 240.14e–3 (1987).

29. 17 C.F.R. § 240.10b–5 (1987).

30. 15 U.S.C. § 78j(b) (1981).

31. Banoff & DuVal, *The Class Action as a Mechanism for Enforcing the Federal Securities Laws: An Empirical Study of the Burdens Imposed*, 31 WAYNE L. REV. 1, 47 (1984).

32. Congress is now considering doing so. *See supra* note 11.

33. § 10(b) prohibits "deceptive or manipulative" words or conduct, but does not reach conduct that is merely unfair. Santa Fe Indus. v. Green, 430 U.S. 462 (1977).

34. This view was accepted, as to fiduciaries, in *Chiarella*. *See infra* text accompanying notes 37–39.

35. D. LANGEVOORT, *supra* note 1, at 44, 46, 51; Banoff & DuVal, *supra* note 31, at 9 n. 28.

36. *See, e.g.* Cady, Roberts & Co., 40 S.E.C. 907 (1961); SEC v. Texas Gulf Sulphur Co. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

In 1980, an insider trading case finally went to the Supreme Court. In *Chiarella v. United States*,[37] the Court rejected market egalitarianism as a basis for the prohibition, holding that those who possess material, non-public information are not forbidden to trade on it merely because others in the market do not have the information and cannot obtain it.[38]

Instead, the Court focused on the language of § 10(b), which limits the scope of Rule 10b-5 to "manipulative or deceptive" words and conduct.[39] At common law, silence is "deceptive" only where there is a duty to speak. According to the Court, only fiduciaries have such a duty.[40] The Court therefore held that trading on non-public information, whether "market" or corporate, violates Rule 10b-5 only when the trader has violated a fiduciary duty.

Thus, after *Chiarella*, fiduciaries may not trade on information about their company or the market for its securities. However, the Court reserved two questions about the extent to which those who are not fiduciaries of the issuer may nevertheless violate the rule if they are "tipped" by a fiduciary, or if they misappropriate the information in violation of a duty owed to someone other than the issuer.

2. *Tippees*

Three years after *Chiarella*, the Supreme Court decided a case on tippee liability. In *Dirks v. SEC*,[41] the Court held that "tippees" violate Rule 10(b)-5 only if the "tipper" breached his or her fiduciary duty in conveying the information.[42] A breach of duty occurs only if the tipper received a personal pecuniary benefit from the tip, although that benefit may take the form of reputational advantage or a gift to a friend or relative.[43] Further, the tippee must know that the information is material and non-public, and must also know[44] that the tipping insider is receiving a personal benefit.[45] The tippee's pecuniary benefit is irrelevant; if the tipper did not breach a duty, the tippee may trade.

37. 445 U.S. 222 (1980).

38. *Id.* at 232–33.

39. *Id.* at 226–27.

40. *Id.* at 234–35. Prof. Langevoort argues that the Court's view of the common law was inaccurate. D. LANGEVOORT, *supra* note 1, at 63–64.

41. 463 U.S. 646 (1983).

42. *Id.* at 660.

43. *Id.* at 666–68.

44. Tippee liability thus rests on a "double *scienter*" requirement. It is not enough that the tippee merely knows the information is material and non-public. SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

45. If the tippee actually trades, both the tipper and the tippee violate the rule. If the tippee does not trade (or tip in turn) the tipper may nevertheless be subject to the sanctions. Faberge Inc., 45 S.E.C. 249 (1973). However, this issue has not been conclusively decided by the courts.

3. *Temporary Insiders*

In a footnote in *Dirks*, the Supreme Court stated that outsiders who occupy a special confidential relationship with the issuer, such as underwriters, accountants, and attorneys, may become fiduciaries of the shareholders.[46] However, the issuer must expect that information given to "temporary insiders" will not be disclosed or, presumably, used for personal benefit. Further, the nature of the relationship must make that expectation reasonable.[47]

4. *Misappropriaters*

The Supreme Court has not yet decided whether someone who is not a fiduciary of the company whose shares are being traded, but who misappropriates confidential information and uses it to trade, violates Rule 10b-5. In *Carpenter v. United States*,[48] an evenly divided Court affirmed without discussion the petitioners' convictions under Rule 10b-5 for engaging in a conspiracy to misappropriate information about the publication schedule of the *Wall Street Journal* (for which one of them worked) so that they could purchase stock they knew a *Journal* column would recommend.

The Second Circuit, whose ruling was affirmed, had held that the deceitful conversion of an employer's confidential information was a fraud on the employer. Since that information was used for trading, the court held that the fraud was "in connection with" the purchase or sale of a security and therefore violated Rule 10b-5.[49] Unless or until another case goes to the Supreme Court, that holding will stand.

The *Carpenter* Court did hold, unanimously, that the defendants' conduct violated the federal mail and wire fraud statutes.[50] Prosecutors presumably do not care which law sends an inside trader to jail.[51] The only effect, therefore, of a subsequent decision that misappropriation does not violate Rule 10b-5 would be that the SEC could not bring enforcement actions, and misappropriaters would not be subject to the Insider Trading Sanctions Act, at least in its current form.

B. *Rule 14e-3*

Section 14(e) of the Williams Act[52] outlaws fraudulent, deceptive, or manipulative acts or practices in connection with a tender offer. In 1980, shortly after *Chiarella*, the SEC promulgated Rule 14e-3.[53] The rule prohibits anyone with

46. 463 U.S. at 655 n. 14.
47. *Id.*
48. Carpenter v. United States, *supra* note 27.
49. 791 F.2d 1024 (2d Cir. 1986).
50. Carpenter v. United States, *supra* note 27, at 5–9.
51. *See* Blodgett, *Insider Trading Cures?*, 74 A.B.A. J. 42, 43 (Mar. 1, 1988).
52. 15 U.S.C. § 78n (1981).
53. 17 C.F.R. § 240.14e–3 (1985).

advance knowledge of a tender offer, or of material events during a tender offer, from trading on that information if 1) the offeror has taken a substantial step toward commencement of the bid, 2) the information was acquired from the bidder or the target (and the trader knows or has reason to know this) and 3) the information is non-public.[54]

The rule also makes it unlawful for the bidder, the target, their insiders, or any of their tippees to give non-public information about a tender offer to anyone who is likely to trade.[55]

Rule 14e-3 goes well beyond Rule 10b-5, at least as interpreted by *Chiarella* and *Dirks*. It is not necessary that either the trader or the tipper have a fiduciary duty to the target company's shareholders, nor that the information be misappropriated. For example, bidders may not encourage friendly institutions or arbitrageurs to buy target shares so that they will be tendered, a practice known as "warehousing".[56]

To the extent that conduct which would not be illegal under Rule 10b-5 may be prosecuted under Rule 14e-3, there is some doubt that the rule is valid.[57]

C. Enforcement

1. Criminal

The Securities Exchange Commission may not prosecute criminal cases itself, but it may refer them to the Department of Justice. An increasing number of criminal cases have been brought, with violators frequently sentenced to prison[58] and fined. Some defendants have also been ordered to pay restitution.[59]

2. Securities Exchange Commission

The Commission may bring civil actions in federal court for injunctive relief, disgorgement, and a civil penalty of up to three times the defendant's profits.[60]

54. *Id.*

55. *Id.*

56. *Id.* The bidder may itself purchase shares on the market, however.

57. *See* D. LANGEVOORT, *supra* note 1, at 232–40.

58. G. Lynch & M. Missal, Recent Civil and Criminal Prosecutions of Insider Trading Violations 33–34 (Jan. 1987) (unpublished manuscript), *presented at* Fourteenth Annual Securities Regulation Institute (U.C.S.D. 1987). Probation and mandatory community service appear to have been imposed more frequently, however.

59. *Id.*

60. § 21(d)(1) of the 1934 Act, 15 U.S.C. § 78 (1981) gives the SEC power to seek an injunction, and disgorgement is an ancillary remedy. The Insider Trading Sanctions Act of 1984, 15 U.S.C. § 78u(d)(2) (1981), provides a civil penalty of up to three times the defendant's profits in addition to any other relief the Commission may obtain.

The Commission may also institute disciplinary proceedings against attorneys, accountants, or market professionals.[61]

The Commission has announced that insider trading is a high enforcement priority; from 1980 to the end of 1986, the SEC brought 143 insider trading actions.[62] In 1986 alone, defendants disgorged more than $30 million, and that does not include the $100 million Ivan Boesky was ordered to pay.[63]

3. Private Civil Actions

The Second Circuit has recognized an implied cause of action under Rule 10b-5 for insider trading on behalf of all those who traded on the other side of the market from the insider.[64] Damages, however, are limited to the amount of the defendant's profits.[65] Perhaps because of this limitation,[66] private actions against inside traders are infrequent.

Section 16(b) of the 1934 Act also grants an express right of action to a corporation (or a shareholder suing derivatively) to recover "short-swing" profits made by officers, directors, or more than 10% shareholders within a six-month period.[67]

II. United Kingdom

Until 1980, insider trading was not against the law in the U.K. There was (and is) no common law prohibition; while company directors have stringent fiduciary duties to the corporation, they owe no duties to shareholders.[68] Accordingly, there was no common law duty to "disclose or abstain."[69]

To say that insider trading was not illegal is not to say that it was approved. Both the Stock Exchange and the Panel on Take-Overs and Mergers had rules against insider trading, and several disciplinary proceedings were brought by

61. § 15(b)(4) of the 1934 Act, 15 U.S.C. § 78 (1981), gives the Commission the power to discipline market professionals. The Commission has also used Rule 2(e) of its Rules of Practice to bring administrative proceedings against accountants and attorneys. *See* Marsh, *Rule 2(e) Proceedings*, 35 Bus. Law 987 (1980).

62. *See* G. Lynch & M. Missal, *supra* note 58, at 1.

63. G. Lynch, Remarks at Fourteenth Annual Securities Regulation Institute (U.C.S.D. 1987).

64. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 495 F.2d 228 (2d Cir. 1974); *see also* Wilson v. Comtech Telecommunications, 648 F.2d 88 (2d Cir. 1981).

65. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168–73 (2d Cir. 1980).

66. Even before *Elkind*, private actions for insider trading were rare. Banoff & DuVal, *supra* note 31, at 47.

67. 15 U.S.C. § 78p(b) (1981).

68. Percival v. Wright, [1902] 2 Ch. 421.

69. *Id.* It is even unclear whether the corporation could recover from the insider, although commentators believe that it probably could. *See, e.g.* J. H. Farrar, Company Law 356 (1985); B. Rider, D. Chaikin, & C. Abrams, Guide to the Financial Services Act 1986 ¶ 702 at 98 (CCH Ed. Ltd. U.K. 1987) [hereinafter cited as Guide].

those bodies.[70] In addition, the Companies Act required directors to disclose their interests in their companies' shares[71] and prohibited them from dealing in options on their companies' listed securities.[72]

These statutory provisions and the efforts of the self-regulatory authorities were seen by some as inadequate.[73] After two unsuccessful attempts to amend the statute,[74] the Companies Act was amended in 1980 to make insider trading a criminal offense. In 1985, those sections were re-enacted, with some amendments, as the Company Securities (Insider Dealing) Act.[75] The Insider Dealing Act was in turn amended by the Financial Services Act of 1986, which made substantial changes in the British regulatory system[76] (and which accompanied the "Big Bang's" transformation of the securities market in London).[77]

The Insider Dealing Act is now the primary—and perhaps the only—source of U.K. law in this area.[78] The self regulatory authorities will probably continue to supervise their members and to assist in the detection of insider trading, but their previous substantive regulatory and enforcement roles have been transferred to the Department of Trade and Industry.[79]

Briefly, the Insider Dealing Act (the "Act") makes it a criminal offense for insiders who possess unpublished, price-sensitive information to trade, tip, or counsel others to trade in the securities of the insider's company or, in some cases, other companies. The Act applies only to trades on a stock exchange or in the over-the-counter market; closely held corporations and privately negotiated transactions are not covered.

Public servants and their tippees are also forbidden to trade while in possession of inside information acquired by virtue of their position. Finally, those contemplating a tender offer, and their tippees, may not trade on their own behalf.

70. *See* Rider, *Self-Regulation: The British Approach to Policing Conduct in the Securities Business, With Particular Reference to the Role of the City Panel on Take-Overs and Mergers in the Regulation of Inside Trading*, 1 J. COMP. CORP. L. & SEC. REG. 319 (1978).

71. Companies Act, 1985, ch. 6, §§ 324–29, *reenacting* Companies Act, 1967, ch. 81, §§ 27–29.

72. Companies Act, 1985, ch. 6, § 324, *reenacting* Companies Act, 1967, ch. 81, § 27.

73. *See* J. FARRAR, *supra* note 67, at 346, *citing* The Report of the Company Law Committee (The Jenkins Committee) Cmnd 1749, ¶ 89.

74. Companies Bill 1973 and 1978. These bills were not enacted.

75. Company Securities (Insider Dealing) Act, 1985, ch. 8 [hereinafter cited as Insider Dealing Act]. For a general discussion of the 1980 version, *see* Branson, *Insider Trading: The British Regulation in the Light of the American Experience*, 1982 J. BUS. L. 342 -48, 413–20, 536–42.

76. In addition to the GUIDE, *supra* note 69, which is the only treatise on the Financial Services Act so far, *see* Note, *International Trade: Regulation of London's Financial Markets — The Financial Services Act, 1986*, 28 HARV. INT'L L.J. 196 (1987).

77. GUIDE, *supra* note 69, ¶¶ 211–13, contains a good description of the "Big Bang", which occurred when the Stock Exchange abolished minimum commissions, permitted firms to act both as brokers and dealers, and switched to computerized trading.

78. The statute does not preempt the common law, but as noted earlier, there have been no common law cases.

79. GUIDE, *supra* note 69, ¶ 702, at 98.

The following sections summarize the provisions of the Insider Dealing Act. The subheadings used are not necessarily found in the Act (for example, the Act does not use the word "tippees") but have been chosen for purposes of comparison with United States law.

A. *Insiders*

All insiders are fiduciaries, but not all fiduciaries are insiders. An insider, for purposes of the Act, must be "knowingly connected" with the issuer of the securities traded, or have been connected with the issuer within the previous six months.[80] Only individuals are covered by the Act; corporations are not directly prohibited from trading on inside information, although they may be regarded as aiders and abettors.[81]

Directors are automatically "connected" with the issuer.[82] Officers and other employees are "connected" only where they 1) occupy a position which would reasonably be expected to give access to inside information and 2) would reasonably be expected not to disclose such information except in the performance of their duties.[83] An employee of the issuer who is not in such a position, but who nevertheless happens across inside information, does not violate the Act by trading on it.[84]

B. *Temporary Insiders*

Individuals are also "connected" with the issuer if they occupy a position involving a professional or business relationship with the issuer, or are employed by, or a director of, companies which have such a relationship. Again, however, the position must be one which may reasonably be expected to give access to confidential information, and it must be reasonable to expect someone in that position not to disclose such information except in the proper performance of his or her duties.[85]

C. *Tippees*

Tippees (or, in U.K. parlance, "secondary insiders") are also covered by the Act. A tippee is anyone who knowingly obtains inside information from a "con-

80. Insider Dealing Act *supra* note 75, at § 9; J. FARRAR, *supra* note 69, at 348.

81. GUIDE, *supra* note 69, ¶ 705, at 100.

82. GUIDE, *supra* note 69, ¶ 706, at 100. Directors of related companies (subsidiaries, holding companies, or another subsidiary of a holding company) are also "connected". Those connected with foreign companies are included in the Act. Insider Dealing Act, *supra* note 75, at § 9(a).

83. Insider Dealing Act, *supra* note 75, at § 9(b).

84. GUIDE, *supra* note 69, ¶ 706, at 100.

85. Insider Dealing Act, *supra* note 75, at § 9. This category is quite similar to the "temporary insiders" who may violate Rule 10b-5. *See supra* text accompanying notes 30–51.

nected" person if the tippee 1) knows or has reasonable cause to believe that the tipper received the information by virtue of the tipper's position, 2) knows or has reasonable cause to believe that a person in the tipper's position would reasonably be expected not disclose it, and 3) knows or has reasonable cause to believe that the information is unpublished and price-sensitive.[86]

The tippee must have received specific information. If the tipper has simply advised the tippee to trade, the tippee may do so without violating the Act, even if the advice is accompanied by nudges and winks and the tippee has reason to believe that it is based on inside information.[87]

D. Inside Information

The Act defines inside information as unpublished, price-sensitive information in relation to the securities in which the insider, or the tippee, deals.[88]

Information is "unpublished" if it is "not generally known to those persons who are accustomed or would be likely to deal in those securities."[89] Apparently, it is not necessary that the information be disclosed to the general public; whether disclosure to market professionals suffices has not yet been decided.[90]

Information is "price-sensitive" if it would, if published, "be likely materially to affect the price of those securities."[91] It is not enough that the information would be taken into account in the trading decisions of others. It must also be likely to change the price.

The fact that the information is price-sensitive is a necessary, but not a sufficient, condition. The information must also relate to "specific matters relating or of concern (directly or indirectly) to that company, that is to say, . . . not of a general nature relating or of concern to that company."[92]

The meaning of this language is obscure. The Act apparently distinguishes between corporate information, at least some of which is covered, and market

86. Insider Dealing Act, *supra* note 75, at § 1(3)–(4). J. FARRAR, *supra* note 69, at 351–52. The definition of "secondary insider" is again quite similar to the *Dirks* definition of a "tippee", since it includes the requirement that the tipper breach a fiduciary duty by tipping. *See supra* text accompanying notes 41–45.

87. J. FARRAR, *supra* note 69, at 342. The requirements of specific information should be contrasted with the position of at least one American court which held that merely recommending the stock as a "good buy" was an illegal tip. *See Texas Gulf Sulphur Co.*, *supra* note 36.

88. Insider Dealing Act, *supra* note 75, at § 10(a). *See generally* Herne, *Inside Information: Definitions in Australia, Canada, the U.K, and the U.S.*, 8 J. COMP. CORP. L. & SEC. REG. 1 (1986).

89. Insider Dealing Act, *supra* note 75, at § 10(b).

90. J. FARRAR, *supra* note 69, at 350. It should be noted that, in an efficient market, information disclosed to securities professionals will be reflected in the price, even if uninformed traders do not have access to it.

91. Insider Dealing Act, *supra* note 75, at § 10.

92. Insider Dealing Act, *supra* note 75, at § 10(a).

information, which is not.[93] However, some kinds of corporate information may not be covered by the definition. The problem lies with the meaning of "specific". One commentator suggests that "specific" matters would include dividend payments, changes in capital structure, mergers, acquisitions, or divestitures, and business changes.[94] At the Committee stage, the Minister of Trade stated that "the kind of thing we are after is knowledge of dramatic events, major happenings, and things which will transform the company's prospects."[95]

Thus, in theory, information which is price-sensitive but not "dramatic" or "transforming" may be used to trade.[96] In practice, the courts are likely to look at the actual impact of the information when it is disclosed. If prices changed more than trivially, then the information will probably be held to be both unpublished and specific.[97]

E. Prohibited Conduct

1. Trading

An insider commits a criminal offense if he or she buys or sells securities (including debentures or options)[98] on a recognized stock exchange or through an off-market dealer[99] while in possession of unpublished, price-sensitive information.

While the basic offense lies in trading the securities of the insider's own company, the prohibition extends to the securities of any other company if the inside information relates to an actual or contemplated transaction between the insider's company and that other company, or involving one of them and the securities of the other, or to the fact that a contemplated transaction has been abandoned.[100]

The information must relate to the transaction; information incidentally acquired during negotiations is not covered.[101] The information must be specific;

93. GUIDE, *supra* note 69, ¶ 711, at 104–07; J. FARRAR, *supra* note 69, at 349. In contrast, market information is considered "inside" information in the United States. *See* text accompanying notes 39–47.

94. J. FARRAR, *supra* note 69, at 349. *See also*, GUIDE, *supra* note 69, ¶ 711, at 104.

95. J. FARRAR, *supra* note 69, at 349 n.3.

96. *Id.*

97. *Id.* at 350. In contrast, in the United States courts have tended to focus on whether the information was material to the defendant.

98. Insider Dealing Act, *supra* note 75, at § 12(a); GUIDE, *supra* note 69, ¶ 709, at 102.

99. GUIDE, *supra* note 69, ¶ 708, at 101–02. The DTI views the unlisted securities market as a stock market for purposes of the Act. In contrast to the U.S., however, trading in the securities of private companies is not covered; nor are private transactions in listed companies. J. FARRAR *supra* note 69, at 351.

100. Insider Dealing Act, *supra* note 75, at § 1(2).

101. J. FARRAR, *supra* note 69, at 351.

preliminary negotiations may not rise to that level.[102] Finally, it is not clear whether the term "transaction" requires a bilateral relationship, as opposed to the unilateral intention of the insider's company to acquire or dispose of shares in the other.[103]

The offense requires *scienter*. The insider must have been knowingly connected with the company, must know that the information was obtained by virtue of that position, and must know that it is unpublished and price-sensitive.[104] The offense does not, however, require that the insider use the information in deciding to deal; it is enough that the insider possessed the information by virtue of the connection, and that he or she would be in breach of a duty to the company if the information were disclosed.[105]

Tippees (including remote tippees, if they meet the *scienter* requirements)[106] are subject to the same trading prohibitions as insiders.

2. Tipping

If insiders or their tippees would be prohibited from trading, then they are also prohibited from communicating their information to any person they know, or have reasonable cause to believe, will use the information to trade, or recommend trading, the security.[107] For purposes of establishing the tipper's liability, the tippee may be a company, although companies cannot themselves violate the Act.[108]

The tipper's offense is complete when the information is passed to one likely to make use of it, even if the tippee does not in fact trade or tip in turn. Thus, it is a crime for a non-trading insider to tip a non-trading tippee.[109]

3. Counselling and Procuring

Those prohibited from trading may not recommend that someone else do so, if they know or have reasonable cause to believe that their advice would be followed.[110] "Counselling and procuring" differ from "tipping" in that the specific information is not itself passed along.[111] "Tippees" who trade commit a crime themselves; "counsellees" who trade do not violate the Act, although the counsellor does.[112]

102. Herne, *supra* note 88, at 6.
103. GUIDE, *supra* note 69, ¶ 713, at 105.
104. J. FARRAR, *supra* note 69, at 348–50.
105. GUIDE, *supra* note 69, ¶ 710, at 103.
106. *Id.* ¶ 715, at 107.
107. Insider Dealing Act, *supra* note 75, at § 1(7)–(8).
108. *See id.* § 1(8). *See also* J. FARRAR, *supra* note 67, at 348 n. 13.
109. GUIDE, *supra* note 69, ¶ 719, at 109. In this area, the United Kingdom is more rigorous than the United States.
110. Insider Dealing Act, *supra* note 75, at § 1(7).
111. GUIDE, *supra* note 69, ¶ 718, at 108.
112. J. FARRAR, *supra* note 69, at 352.

4. Tender Offers

The Act also applies to anyone who is contemplating (or has contemplated) making a take-over offer for another company. If that person knows that the fact that such an offer is contemplated (or is no longer contemplated) is unpublished price-sensitive information with respect to the target company's securities, then he or she may not trade, tip, or counsel or procure trading in the securities of the target *except* for the purpose of making or facilitating the offer.[113] That "except" is important; "warehousing" does not violate the Act.[114]

As with insiders, this section applies only to individuals. If a corporation is actually the potential offeror, then an insider of that corporation is not, at least in theory, covered by the section, although a court might be willing to interpret it differently.[115] If a court were not so willing, then a corporate acquiror's insiders would violate the act by trading in target securities only if a contemplated offer is a "transaction" within the meaning of section 1(2) of the Act.[116]

5. Public Servants

Public servants and their tippees are prohibited from trading, tipping, or counselling or procuring, if they are in possession of inside information obtained by virtue of their office which it would be reasonable to expect them not to disclose except in the proper performance of their duties.[117]

F. Defenses and Exemptions

There are five defenses to a charge of insider trading where the facts would otherwise support a conviction.

1. Purpose Other Than To Make a Profit or Avoid a Loss

An insider who trades while in possession of unpublished, price-sensitive information, but who does so "otherwise than with a view to making a profit or the avoidance of a loss,"[118] does not violate the Act. This provision is intended to protect the insider who is forced by circumstances to trade.

The defense has been criticized on the grounds that it permits insiders to "drive a coach and horses through the legislation"[119] because insiders will frequently be able to construct some pressing financial reason for the trade, and will in any

113. Insider Dealing Act, *supra* note 75 at § 1(5); GUIDE, *supra* note 69, at ¶ 716, at 107.

114. "Warehousing" is, however, illegal in the United States, assuming Rule 14e–3 is valid. *See supra* text accompanying note 28.

115. J. FARRAR, *supra* note 69, at 352 n. 3.

116. *See supra* text accompanying note 103.

117. Insider Dealing Act, *supra* note 75, at § 2. Public servants include members and agents of self-regulatory organizations.

118. *Id.* at § 3(1)(a).

119. J. FARRAR, *supra* note 69, at 354 *citing* Sugarman and Ashe (1981) 2 Co. L. 13, 17.

event time the trade to get the best possible result.[120] Other commentators suggest that there will always be an element of profit-making or loss-avoiding in any insider trade; the defense will thus be of little use unless a court decides that profit-making must be the primary (as opposed to a subsidiary) motive for the transaction.[121]

2. Liquidators, Receivers, and Trustees-In-Bankruptcy

A liquidator, receiver, or trustee-in-bankruptcy may trade (or presumably, tip or counsel) while in possession of inside information if he or she does so in the good faith exercise of his or her functions.[122] Since the function of such a position is to protect creditors, the effect of this defense is to prefer creditors to equity holders, or (if the transaction is in debentures) to prefer some creditors to others.

3. Dealers and Market Makers

Dealers (called "jobbers" in the U.K.)[123] and market makers[124] are exempted from the prohibitions of the Act if 1) the information was obtained in the course of business, 2) was of the sort that it would be reasonable to expect a dealer or market maker to obtain, and 3) his or her conduct was in the good faith performance of the business. This defense is particularly interesting because the sort of inside information that dealers and market makers would ordinarily be expected to have is *market* information, which is excluded from the definition of inside information in any event.[125] Accordingly, the defense will only be used when the market professional traded, tipped, or recommended trading while in possession of specific, price-sensitive information about the company.

4. Facilitating The Completion or The Carrying Out of a Transaction

If an individual has already started a transaction, and then comes into possession of inside information that would have prohibited trading, the transaction may nevertheless be completed.[126] This defense also permits a person contemplating a tender offer to trade, tip, or counsel, if the purpose is to facilitate the offer,[127] and allows those connected with a company engaged in (or contemplating) a transac-

120. *Id.* This criticism seems far-fetched; the lightning of inside information doesn't strike that often.

121. GUIDE, *supra* note 69, ¶ 720, at 109.

122. Insider Dealing Act, *supra* note 75, at § 3(1)(b).

123. § 3(1)(c) defines a "jobber" as an individual, partnership or company dealing in securities on a recognized stock exchange and recognized by the council of the Stock Exchange as carrying on the business of a jobber.

124. The Financial Services Act, 1986, ch. 60, § 174(2) defines a market maker as an individual, partnership or company, who is at all times ready to buy or sell securities at a specified price, in compliance with the rules of (and recognized by) a stock exchange.

125. *See supra* note 93.

126. *See supra* text accompanying note 93. Insider Dealing Act, *supra* note 75, at § 3(2).

127. *See* Insider Dealing Act, *supra* note 75, at § 3(2)(a).

tion with another company to trade, tip, or counsel with respect to the securities of the second company if the purpose is to facilitate the transaction.[128]

5.Fiduciaries

Trustees and personal representatives, which include investment bankers, commercial bankers, and fund managers, may trade on behalf of their beneficiaries while in possession of unpublished, price-sensitive information if they act on the advice of a person who appears to the fiduciary to be both appropriate and not prohibited from dealing—for example, a stockbroker who does not possess the information.[129]

It seems somewhat strange that the knowledgeable can absolve themselves by seeking advice from the ignorant, particularly when the circumstances may make quite clear the purpose for which the advice is sought.[130] However, there were two purposes for this provision: to permit fiduciaries to protect beneficiaries, and to protect fiduciaries against claims by beneficiaries.[131]

G. Enforcement

1. Investigations

The Financial Services Act substantially increased the enforcement powers of the Department of Trade and Industry (DTI) in investigating suspected insider trading. The DTI may now appoint one or more inspectors[132] who may require the production of documents and take testimony under oath.[133] An unreasonable refusal to cooperate is subject to contempt proceedings in the High Court.[134] If

128. *Id.* This clearly demonstrates that the U.K.'s prohibition of inside trading is based on a breach of fiduciary duty, not market egalitarianism.

129. *Id.* at § 7. If the fiduciary acts on such advice, then it is presumed that defense #1 (purpose other than seeking profit or avoiding loss) is met. J. FARRAR, *supra* note 69, at 355.

130. If the fiduciary customarily uses "in house" investment advice, but goes to an outsider to take advantage of the § 7 defense, the outsider may be able to decode the reason the advice is requested.

131. GUIDE, *supra* note 69, ¶ 723, at 111.

132. Financial Services Act, 1986, ch. 60, § 177(1).

133. *Id.* Statements made by a person complying with an inspector's request may be used in evidence against him or her. However, § 177(7) provides that an inspector may not demand information subject to legal professional privilege. Further, § 177(8) provides that banks need not disclose information related to customers unless 1) the inspectors have a reasonable belief that the customer "may be able to give information concerning a suspected contravention", and 2) the Secretary of State believes that disclosure of information is necessary.

134. *Id.* at § 178(2)(a). In one interesting case, a British journalist was fined £ 20,000 for failing to comply with a DTI demand that he reveal his sources. The journalist had written newspaper articles which accurately forecast the outcome of government decisions on whether to permit certain mergers. The DTI was investigating whether leaks from the relevant government offices had resulted in insider trading. The journalist was not himself charged with such trading, but the DTI thought his sources might also be tipping others. The journalist continues to refuse to reveal his sources, and his

the recalcitrant subject is in the investment business, the Secretary of State may also cancel or restrict that person's authorization to carry on business.[135]

The subject of a request for documents or testimony may not avoid it merely because he or she did not know the identity of the principal for whose accounts trades were made.[136] Further, a foreign "blocking" statute[137] apparently may not be used as an excuse unless an attempt was actually made to secure authority from the client, pursuant to the foreign law, for the disclosure of the information or documents requested.[138]

2. Penalties

1. Civil

There are no civil penalties for violating the Act, although the Securities Industry Board (SIB) has suggested that it may use its new powers under the Financial Services Act to bring an injunctive proceeding or a restitution order requiring the insider to disgorge profits.[139]

Parliament considered, but decided against, including an express civil right of action for damages for insider trading, although it did include a general provision permitting a private right of action to anyone who suffered a loss by reason of a violation.[140]

b. Criminal

Anyone indicted and convicted of an offense under the Act may be sentenced to a maximum of two years or fined in an unspecified amount.[141] If the summary conviction procedure is used, the maximum penalty is six months imprisonment and/or a fine not exceeding the statutory maximum (currently £ 2000.)[142] While criminal courts in England are empowered to make compensation orders, it is unlikely that they will do so in cases of insider trading.[143]

As of early 1987, there had been seven prosecutions and five convictions under

---

newspaper has paid his fine. 1 INT'L SEC. REG. REP. 7–8 (Dec. 23, 1987); *Id.* at 8–9 (Feb. 3, 1988). *See also* Tridimas, *The Financial Services Act and the Detection of Insider Trading*, 8 Co. L. 162 (1987).

135. *Id.* at § 178(3).

136. *Id.* at § 178(6)(a).

137. *Id.* at § 178(6)(b).

138. GUIDE, *supra* note 69, ¶ 732, at 119.

139. *Id.* ¶ 734, at 121.

140. *Id.*

141. Insider Dealing Act, *supra* note 75, at § 8.

142. *Id.*

143. GUIDE, *supra* note 69, ¶ 733, at 120. Compensation orders tend to be confined to direct, personal transactions, and the Insider Dealing Act only applies to stock-exchange transactions. The government has introduced a bill that would increase the maximum penalty to seven years imprisonment and make insider trading extraditable. 1 Int'l Sec. Reg. & L. Rep. (BNA) 4 (Mar. 2, 1988).

the Act and its predecessor.[144] More cases were pending. So far, at least, the sentences imposed have not been very heavy; no one has gone to prison.[145] However, the offenders have all either resigned their posts or have been removed by their employers.[146] In the "Gentlemen's Club" of the City, being asked to resign one's membership may be a fate worse than jail.

III. JAPAN

An American lawyer would find the Japanese securities statute quite familiar. Japan's Securities Exchange Law of 1948 ("S.E.L.")[147] was copied directly from the United States' Securities Act of 1933[148] and Securities Exchange Act of 1934.[149] This wholesale adoption of American law did not occur because the Japanese thought American law was better than their own; the post-war Occupation authorities insisted on it as a condition to reopening the Japanese stock exchanges.[150]

It might be expected that law imposed by force would be abandoned when the force departed. Interestingly, however, this did not occur. As soon as the Occupation forces left, Japan did start to amend the statute. For example, in 1952, the Securities and Exchange Commission was abolished and replaced with a Securities Bureau in the Ministry of Finance.[151]

Nevertheless, although the S.E.L. has been amended more than 20 times since its enactment, it continues to follow the American statutes. Indeed, several of the amendments have tracked post-1948 developments in American securities law,[152]

144. *Id.*

145. J. FARRAR, *supra* note 69, at 357.

146. *Id.*

147. *Shōken Torihiki Ho* (Securities Exchange Law), Law No. 25 of 1948 (amended 1971). [hereinafter cited as S.E.L.].

148. 15 U.S.C. §§ 77a -77aa (1981).

149. 15 U.S.C §§ 78a-78KK (1981).

150. Yazawa, *A Synopsis of Securities Regulation in Japan*, in JAPANESE SECURITIES REGULATION, ch. 1-B, 29 (L. Loss, M. Yazawa & B. Banoff ed. 1983); Ishizumi, *Insider Trading Regulation: An Examination of Section 16(b) and a Proposal for Japan*, 47 FORDHAM L. REV. 449, 451 (1979).

151. Yazawa, *supra* note 150, at 25; *see generally* Tatsuta, *Enforcement of Japanese Securities Legislation*, 1 J. COMP. CORP. L. & SEC. REG. 95, 96–97 (1978); Ishizumi, *supra* note 150, at 488–89. Initially, there was only a section of a bureau of the Ministry of Finance, but it was then upgraded to the Securities Bureau.

The switch from independent regulatory commission to executive branch bureau enabled the government to coordinate securities regulation with the perceived needs of economic growth (and occasionally to subordinate it, when economic development or long-standing business practices clashed with investor protection). Tatsuta, *supra* at 101.

152. Yazawa, *supra* note 150, at 33. For example, the 1971 amendment was based on the 1964 amendments to the U.S. Securities Exchange Act. Under the amendment, issuers of securities listed on an exchange or quoted over the counter are required to file semi-annual and current reports.

and the Japanese continue to pay close attention to changes in American securities regulation.

In short, the Japanese system looks very like the American system on paper.

A. Statutory Provisions

The S.E.L. contains three sections, called "articles" in Japan, which apply (or could apply) to insider trading.

1. Short-swing profits

Article 189 is the Japanese counterpart to section 16(b) of the U.S.'s 1934 Act. Article 189 provides for an issuer's recovery of short-swing trading profits from its officers, directors, or more-than-10% shareholders derived from any sale and purchase, or purchase and sale, of the issuer's equity securities within a six-month period.[153] As in the U.S., a shareholder may bring an action in the right of the issuer if, after demand, the issuer fails to bring its own action.[154]

There is, however, one striking difference between the American and Japanese legislation. In 1953, Japan repealed its version of section 16(a), which requires insiders to report their trades.[155] While this repeal has been criticized by Japanese commentators,[156] its result has been to nullify Article 189. Only one action has ever been brought under that provision, and that action, which was unreported and presumably settled, grew out of an internal management struggle.[157]

2. Antifraud

Article 58 of the S.E.L. is a general antifraud provision which is based on Rule 10b-5.[158] In theory, violations of Article 58 are subject to penal sanctions[159] and to injunctive relief.[160]

In fact, Article 58 has been applied only in a small number of disciplinary cases against brokerage firms, and never for insider trading.[161] There have been

153. Tatsuta, *Proxy Regulation, Tender Offers, and Insider Trading*, in JAPANESE SECURITIES REGULATION, ch. VIII at 194. (L. Loss, M. Yazawa, and B. Banoff, ed. 1983).

154. *Id.*

155. *Id.* Tatsuta states that the provision had been easy to evade; it did not require reporting beneficial ownership and the government did not publicize the reports. The government chose to repeal the provision rather than correct these difficulties.

156. Tatsuta, *supra* note 151, at 112; *id.* at n.139; Ishizumi, *supra* note 150 at 488–89.

157. Tatsuta, *supra* note 153, ch. VIII, at 192; *id.* at n.138. The *Shokusan-Jutaku Case* was brought by new management against its former chairman to recover his short-swing profit.

158. *Id.*

159. *Id*; S.E.L., *supra* note 147, at art. 197.1. (2).

160. Tatsuta, *supra* note 153, ch. VIII, at 192; S.E.L., *supra* note 147, at art. 187.

161. Tatsuta, *supra* note 153, ch. VIII, at 192; Ishizumi, *supra* note 147, at 487.

no prosecutions, and the Ministry of Finance has never applied for an injunction under this (or any other) article.[162] Article 58 has "simply been inactive."[163]

Nor is the gap in enforcement likely to be remedied by private litigation. There are no implied private rights of action under Article 58[164] and, even if there were, it is doubtful that Japanese courts would find a fiduciary duty running from management to shareholders which would support a "disclose or abstain" rule.[165] In any event, given both the traditional Japanese reluctance to litigate and the substantial barriers to litigation in the Japanese structure,[166] even a judiciary inclined to substantially more activism than the Japanese would find few occasions to exercise that inclination.

3. *Broker-Dealer Regulation*

Article 50 of the S.E.L. regulates the management and employees of "securities corporations" (brokers, dealers, and underwriters) and gives the Minister of Finance the authority to prohibit activities which prejudice the protection of investors, are detrimental to the fairness of transactions, or undermine the creditability of the securities industry.[167]

Pursuant to this authority, the Minister promulgated the "Soundness Ordinance",[168] which regulates a wide variety of broker-dealer conduct.[169] Among its provisions, the Soundness Ordinance prohibits the management or employees of securities corporations from engaging in securities transactions which take advantage of non-public information obtained by virtue of their position.[170]

In theory, if a securities corporation or its employees violate the Ordinance, the Minister of Finance may revoke the firm's license, suspend it from business, or revoke or suspend the employee's license.[171] In practice, it is quite rare for the

162. *Id.*

163. Tatsuta, *Japan*, in INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION, ch. 11, § 11.10 (H. Bloomenthal ed. 1987).

164. *Id* at 11–33.

165. It is not clear that Japanese directors have any fiduciary duties other than the duty of care. Note, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. HAW. L. REV. 135, 182 (1983). Further, judicial development is unlikely because Japanese judges are reluctant to entertain novel policy arguments, *id.* at 184, and because Japan does not have a common law system. Ishizumi, *supra* note 150, at 494 n. 246.

166. *See infra* text accompanying notes 189–91.

167. *See* Tatsuta, *supra* note 153, ch. VIII, at 193.

168. *Shōken Gaisha no Kenzensei no Junsoku tō ni Kansuru Shōrei* (Ministerial Ordinance on Standard of Soundness for Securities Corporations) Ministry of Finance no. 60 of 1965, art. 1.1.(5).

169. *See* Tatsuta, *supra* note 151, at 107–08.

170. *Id. See also*, Tatsuta, *supra* note 153, ch. VIII, at 193. The ordinance creates an interesting contrast with United Kingdom law. In the U.K. dealers and market makers are *exempted* from the Insider Dealing Act if the information was obtained in the course of business and used in a performance of the business. *See supra* text accompany notes 123–25.

171. S.E.L., *supra* note 147, at arts. 35, 64.3.

Minister to use these weapons.[172] Instead, the Government, the Stock Exchanges, and the major securities firms have issued periodic warnings and have instituted in-house guidelines.[173] The academic commentators, at least, believe these efforts to be insufficient.[174]

4. Proposed Legislation

The Ministry of Finance has proposed new legislation which would explicitly address insider trading.[175] The proposal defines inside information in terms of its price sensitivity, including information about mergers and acquisitions, new issues of securities, new products, and changes in balance sheet positions. Only exchange-listed securities would be covered.

The law would apply to fiduciaries (including not only officers and directors, but also employees of the issuer whose shares are being traded), "temporary insiders" such as attorneys, accountants, and investment bankers, and their tippees.

Whether or not the proposed legislation is passed,[176] it is unlikely that it will be enforced any more rigorously than is currently the case. The proposal does not provide for a private right of action, and does not contain specific penalties for violation.[177] The MOF would not enforce the law itself,[178] and does not plan to increase its staff or budget to provide additional monitoring.

B. Enforcement

As noted above, the Japanese system looks very like the American system on paper. There are, however, major differences in practice. The statutory provisions which might be used to prohibit or discourage insider trading are not enforced.[179]

This lack of enforcement might be attributed to the fact that most Japanese do

172. Tatsuta, *supra* note 151, at 107. There have been eight cases of administrative sanctions, all of them suspensions of part of the business for one to three days.

173. *Id.* at 112. *See also* Ishizumi, *supra* note 150, at 491; Yanase, *Disclosure System*, in JAPAN SECURITIES RESEARCH INSTITUTE LECTURES ON JAPANESE SECURITIES REGULATION 65, 76–78 (1980).

174. *See, e.g.* Tatsuta, *supra* note 151, at 112. *But see* Ishizumi; *supra* note 150, at 493–94; *id* at n. 247 (while law should be strengthened, administrative guidance and self-regulation may be the most efficient and least costly system for Japan).

175. 1 Int'l Sec. Reg. Rep. (BNA) 1 (Mar. 16, 1988).

176. At least one observer doubts that it will pass. Professor Yoichi Mazuzoe said that up to one third of the Diet engages in insider trading, which supplies about half the money used for political campaigns. *Id.*

177. A Ministry of Finance official says that the penalties will probably be "much less" than those currently available under the securities laws. *Id.*

178. As noted earlier, Japan does not have an independent regulatory agency such as the SEC. Cases would be brought by the ordinary criminal prosecutors' offices, assisted by the police. *Id.*

179. *See* Tatsuta, *supra* note 153, ch. VIII, at 192; Tatsuta, *supra* note 151, at 112 (government exhortations "mere dog howlings").

not think there is anything wrong with insider trading,[180] but that is at best only a partial explanation. There is almost no public or private enforcement of any of the provisions of the securities law in Japan, whether or not they involve insider trading.

The S.E.L. contains elaborate statutory enforcement mechanisms, largely drawn from the American statutes, which include criminal penalties, administrative sanctions, and private rights of action. These enforcement mechanisms are almost never used. In some cases, they have deliberatley been weakened.[181] In others, substantive prohibitions remain on the books but are ignored.[182] These differences between "law on the books" and "law in action" reflect fundamental differences in Japanese attitudes toward law, litigation, and permissible business activities.[183]

First, Japanese rarely litigate, nor do they use lawyers very often. While the Japanese use legally-trained personnel in a wide variety of roles,[184] Japan has very few lawyers engaged in the formal practice of law. In 1984, Japan had only about 12,000 practicing attorneys; the number of lawyers *per capita* was roughly one-seventeenth that of the United States.[185] In 1982, the California state courts heard more than eleven times as many civil cases, on a *per capita* basis, than did those of Japan.[186] This comparative lack of civil litigation is even more striking in the securities area; there has only been one private action brought under any of the S.E.L.'s provisions[187] and the Minister of Justice has never brought an action for injunctive relief.[188]

180. *See* Tatsuta *supra* note 153, ch. VIII, at 192. Professor Tatsuta suggests elsewhere, however, that views of the morality of inside trading may be changing, due in part to the publicity received by American cases. Tatsuta, *supra* note 151, at 112.

181. *See supra* note 155.

182. For example, although market manipulation is officially illegal, certain manipulative practices are considered normal ways or doing business. Kawamoto, *Regulation of Exchange Markets*, in JAPANESE SECURITIES REGULATION, ch. VI, at 126–27 (L. Loss, M. Yazawa, and B. Banoff eds. 1983).

183. The Japanese are not particularly bothered by the gap between law and practice. Kenbler, Maundheim & Shapiro, *Panel Discussion on Corporate Governance U.S., German, and Japanese Perspective*, 8 J. COMP. BUS. & CAP. MKT L. 401, 405 (1986) (the Japanese are formalists, not legalists; cultural answer and legal answer may differ).

184. *See generally* Kanter, *The Japan — United States Treaty of Friendship, Commerce, and Navigation: Lawyers As Treaty Traders*, 8 U. HAW. L. REV. 339 (1986).

185. Tanaka, *The Role Of Law in Japanese Society: Comparisons with the West*, 19 U. BRIT. COLUM. L. REV. 375, 376 (1985).

186. *Id.* at 377. Professor Tanaka also noted that the *per capita* number of civil lawsuits in the United Kingdom and West Germany was approximately ten times & twelve times that of Japan, respectively.

187. *See supra* note 162. In contrast, approximately 2,292 private securities actions either originated in or were transferred into the Southern District of New York in the period from July 1, 1966 to June 30, 1973. Banoff & DuVal, *supra* note 31, at 41 (1984).

188. *See supra* note 163.

While the data is clear, the reasons for the comparative lack of litigation in Japan are more controversial. One view is that the Japanese culture values harmony and conciliation; litigation is a threat to this cultural norm.[189] A variation on the "cultural norm" explanation attributes the lack of civil litigation to a sharp traditional division between the public and private spheres in Japan; private civil litigation simply is not used to enforce public goals.[190]

A contrasting view is that Japan's institutional barriers to litigation—no class actions, no contingent fees, limited discovery, and a shortage of both lawyers and judges—make litigation unprofitable.[191]

The truth may lie somewhere between the "cultural norm" and "institutional barrier" explanations. As one noted Japanese scholar has suggested, cultures change over time and, with the growing urbanization and industrialization of Japan, litigation may become respectable and barriers may lower.[192]

Whatever the reasons, there remains a substantial disparity between what the statute says and what actually happens. Japan's regulation—or, more accurately, non-regulation—of insider trading presents, in microcosm, this difference between "law on the books" and "law in practice".

Further, despite the periodic exhortations against insider trading issued by the Government, the stock exchanges, and the academics,[193] and despite the proposed legislation,[194] the situation is unlikely to change.

IV. Conclusion

I suggested at the beginning of this article that a comparative study of insider trading was useful for two reasons. First, multi-national cooperation in enforcement is easier if the countries involved have similar laws. Second, the existence of developed securities markets in countries which do not prohibit insider trading (or, like Japan, do not enforce a paper prohibition) provides a laboratory for future empirical research which may support or refute some of the claims made by its proponents and opponents.

The insider trading laws of the United States and the United Kingdom are similar, although certainly not identical. The regulatory structure is also similar.

189. Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 YALE L.J. 604, 607–08 (1985); Tanaka, *supra* note 185, at 379–80; Note, *Corporate Governance in Japan*, *supra* note 165, at 139 n. 6.

190. Ishizumi, *supra* note 150, at 488–90. Ishizumi does not, however, explain the lack of *public* enforcement of public goals.

191. Ramseyer, *supra* note 189, at 631–34. Tanaka, *supra* note 185, at 380–84. Ramseyer argues that the barriers are created or maintained to enforce the nonlitigation ethos in order to benefit the administrative bureaucracy, since the absence of litigation concentrates power in their hands.

192. Tanaka, *supra* note 185, at 386–88.

193. Tatsuta, *supra* note 153, ch. VIII, 192; *id.* at n. 137; Tatsuta, *supra* note 151 at 112.

194. *See supra* text accompanying notes 177–78.

Both countries now have computerized trading records,[195] and both have announced that insider trading is an enforcement priority.[196] The prospects for cooperative enforcement are therefore quite good.

The framework for such cooperation already exists. The United States and the United Kingdom have signed a Memorandum of Understanding[197] involving the Securities Exchange Commission, the Commodities Futures Trading Commission, and the Department of Trade and Industry. An enforcement agency in one country may submit a written request for assistance to the other, stating the subject of the investigation, the rule violated, the grounds to suspect the subject is involved, and why the request is reasonably relevant to the investigation.[198]

Each country, of course, retains the right to refuse assistance, but they have agreed that requests will be denied only on the basis of public interest. If a request is denied, and the requesting agency objects, the request is to be evaluated by a senior authority who will certify whether or not the request meets the terms of the agreement. If that authority decides against the requesting agency, it may in turn challenge that decision in writing if it has substantial grounds to do so.

The prospects of cooperation with Japan are more problematic. The Ministry of Finance does issue periodic exhortations against insider trading, and as noted earlier, is introducing new legislation to prohibit it. The Securities Bureau has signed an agreement with the SEC to facilitate requests for surveillance and investigatory information on a case-by-case basis,[199] and Chairman Ruder of the SEC recently met with several Japanese regulatory and exchange officials, where he was assured that information would be available.[200] A similar agreement has been signed between the Securities Bureau and the United Kingdom's Department of Trade and Industry,[201] and Japanese delegates attended an informal conference of regulatory officials from nine countries, hosted by the DTI, which discussed establishing a network of bi-lateral agreements.[202]

None of the agreements, however, requires the requested agency to comply, and none of them relates to information that the regulatory body has not already collected. It remains to be seen whether Japan is willing to commit the necessary

195. *See supra* note 77. Computerization makes it easier to conduct surveillance programs.

196. *See supra*, text accompanying note 62. The British government's White Paper on the Financial Services Act emphasized vigorous enforcement. Tridimas, *supra* note 134 at 165. Moreover, the provisions of the Financial Services Act that enhanced the investigative powers of the DTI were brought into force earlier than the government had originally planned. Pennington, *Insider Dealing and the Financial Services Act, 1986*, 131 SOLIC. J. 206.

197. *See generally* Goelzer, Sullivan, & Mills, *Securities Regulation in the International Market Place: Bilateral and Multilateral Agreements*, in this volume.

198. *Id.*

199. *Id.*

200. 20 Sec. Reg. & L. Rep. (BNA) 287 (Feb. 26, 1988).

201. 19 Sec. Reg. & L. Rep. (BNA) 549 (Apr. 17, 1987).

202. *Id.* at 24 (Jan. 2, 1987).

resources to investigate violations. Further, it is difficult to see how the Japanese will benefit from this; since they do not enforce their own laws against insider trading, they may not make much use of a power to request investigative assistance from the United States.

If Japan's functional non-regulation of insider trading makes the prospect of effective cooperative enforcement efforts problematic, it at least should help researchers interested in testing some of the arguments about insider trading.

For example, it ought to be possible to determine whether investors believe they are harmed by insider trading by comparing the prices of stocks which trade on more than one international exchange.[203] Investor confidence might be measured by looking at comparative levels of investment, and the claim that corporations are harmed, either by a reduction in the flow of information internally or by premature leakage of confidential information[204] might be measured by examining the comparative competitiveness of issuers in their product markets.

I suspect that such researchers will find that the level of investor confidence in the Japanese markets is high,. that stocks do not trade at differential prices, and that Japanese corporations are competitive. Of course, no amount of economic analysis will persuade those who believe that insider trading just isn't fair[205]— and the members of Congress who draft securities legislation fall into that group.[206] It is likely, therefore, that inside traders will continue to get rich in Japan and go to jail in the United States.

203. To the extent that insider trading represents a cost to less-informed professional traders, those traders can protect themselves by increasing the price at which they are willing to sell and reducing the price at which they are willing to buy. Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189 (1986). If market professionals believe that they are significantly more at risk in trading on the Japanese exchange, the prices of stocks trading on that exchange should reflect that risk.

204. *See supra* note 3.

205. *See supra* note 4.

206. *See supra* note 5.