Summer 2012

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The Global Crackdown on Insider Trading: A Silver Lining to the “Great Recession”

CHRISTOPHER P. MONTAGANO*

ABSTRACT

The wake of the Great Recession marked a period of increased enforcement of insider trading violations by nation-states and self-regulatory organizations overseeing stock markets around the world. Before discussing the heightened global enforcement of insider trading, this Note explains the development of insider trading regulation by focusing on U.S., EU, and China law. This Note argues that the heightened global enforcement of insider trading violations in the wake of the Great Recession is a sign of a shared perception by market regulators around the world that there is a need to restore market confidence. Strong enforcement of insider trading regulations is one way market regulators can restore confidence in their marketplaces by showing all investors that they may indeed sit on equal footing. This facilitation of stock market investment in turn promotes capital market development and enables economic growth.

INTRODUCTION

“For years, traders in the financial markets stood more risk of getting struck by lightning on the golf course than they did of being arrested for swapping a few share tips on the same fairways.” ¹

The defendant stockbroker of the Securities and Exchange Commission’s (SEC) first successful insider trading prosecution of a

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corporate outsider was suspended for twenty days from the New York Stock Exchange (NYSE) and fined $3,000, the equivalent of roughly $23,000 today. The penalties were minimal and may have actually improved the broker’s business. According to one source, “[c]lients after a broker with an edge lined up to hire him.” Today, the risk-benefit analysis is much different. Several months ago, Raj Rajaratnam, a former hedge fund manager, was sentenced to eleven years in jail and fined over $156 million, the stiffest penalty ever assessed for insider trading in the United States. In addition to the heightened severity of penalties, the sheer number of insider trading suits brought by the SEC has also increased. In 2010, the SEC prosecuted fifty-three insider-trading cases against 138 defendants, marking a 40 percent increase from the prior year.

U.S. regulators have long believed that strong enforcement of the SEC’s securities regulations, including its prohibition of illegal insider trading, promotes development of U.S. capital markets by facilitating investment in its stock markets. In the late 1990s, the SEC explained:

More Americans are investing in the stock market than ever before . . . . We believe this reflects Americans’

2. The 1961 case of In re Cady Roberts & Co. was the SEC’s first successful prosecution of someone other than a corporate insider (i.e., director, officer, or employee) for insider trading using the antifraud provisions of the Securities and Exchange Act of 1934 (i.e., Section 10(b) and Rule 10b-5). Tipping the Scales: The Fight Against Crooked Trading Gathers Pace, ECONOMIST, Oct. 15, 2011, at 83, 83 [hereinafter Tipping the Scales], available at http://www.economist.com/node/21532280/print. See also infra note 52.

3. Tipping the Scales, supra note 2.

4. I adjusted 1961 dollars to 2011 dollars for inflation using the CPI Inflation Calculator. CPI Inflation Calculator, DEP’T OF LABOR, BUREAU LABOR STAT., http://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 4, 2012) (enter the value “$3,000”; then choose the first year to be “1961”; then choose the second year to be “2011”; then click “Calculate”).

5. Tipping the Scales, supra note 2.

6. Press Release, SEC, SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam (Nov. 8, 2011), http://www.sec.gov/news/press/2011/2011-233.htm (detailing that Rajaratnam faced simultaneous criminal charges by the Department of Justice and civil charges by the SEC that resulted in: an eleven-year jail sentence; an order to pay over $53.8 million in forfeiture of illicit gains; an order to pay $10 million in criminal fines; and an order to pay a civil monetary penalty of $92.8 million to the SEC).

7. Tipping the Scales, supra note 2.

trust and confidence in the American stock markets and that trust stems from a belief that our government relentlessly pursues its mandate to maintain the fairness and integrity of the stock markets. An essential part of our regulation of the securities market is the vigorous enforcement of our laws against insider trading, an enforcement program, the Chairman noted, that "reasonate[s] [sic] especially profoundly" among American investors.\(^9\)

The Chairman of the SEC at that time, Arthur Levitt, further explained: "Our markets are a success precisely because they enjoy the world's highest level of confidence. Investors put their capital to work—and put their fortunes at risk—because they trust that the marketplace is honest."\(^10\) In the wake of the Great Recession,\(^11\) the SEC, like countless other federal and state agencies, is using every tool at its disposal to restore confidence in U.S. markets in hopes of restoring the economy. In 2009, Robert Khuzami, the current Director of the SEC's Division of Enforcement, stated, "[r]ecovery from the fallout of the financial crisis requires important efforts on various fronts, and vigorous enforcement is an essential component, as aggressive and even-handed enforcement will meet the public's fair expectation."\(^12\)

The belief that insider trading corrodes confidence in stock markets and removes capital from the marketplace is no longer confined to the United States. From Europe to Asia, the Great Recession spawned a global desire to rid the world's markets of insider trading.\(^13\)

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9. Id. (quoting Arthur Levitt, Chairman, SEC, A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading, Address Before the "SEC Speaks" Conference (Feb. 27, 1998)).


11. The "Great Recession" is a term used to describe the recession in the late 2000s, and the extremely slow period of economic growth that followed. See David Wessel, Did 'Great Recession' Live Up to the Name? WALL ST. J. (Apr. 8, 2010), http://online.wsj.com/article/SB10001424052702303591204575169663166352882.html.


In early 2011, the United Kingdom sentenced an ex-banker to the longest prison term in its history for insider trading. The United Kingdom’s Financial Services Authority (FSA) did not commence its first criminal conviction for insider trading until 2008; yet, only one year later, the FSA fined its financial industry a record-setting £34.8 million. Two years later, the FSA opened over one hundred insider trading investigations.

Evidence of the United Kingdom’s recent focus on insider trading is representative of a shift occurring across Europe. On October 20, 2011, the European Union (EU) unveiled two new EU directives—Markets in Financial Instruments Directive (MIFID II), and Market Abuse and Criminal Sanctions—to “reinforce the investigative and sanctioning powers of regulators” and to “ensure minimum criminal sanctions for insider dealing and market manipulation.” The EU Internal Market and Services Commissioner Michel Barnier said, “[b]y imposing criminal sanctions for serious market abuse throughout the EU we send a clear message to deter potential offenders—if you commit insider dealing or market manipulation you face jail and criminal record.”

The attack on insider trading is not isolated to Western markets. On December 1, 2011, in his first public speech after being named chairman of the China Securities Regulator Commission (CSRC), Guo Shuqing said, “[h]ere we make a solemn declaration: the CSRC has zero tolerance for insider trading and crimes in the securities and futures

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15. See Kitching, *supra* note 13 (describing the criminal proceedings against Christopher McQuoid and James Melbourne, McQuoid’s father-in-law, for insider trading in January 2008 regarding information about Motorola’s takeover of TTP).


19. *Id.*
markets." Many Chinese investors and observers share a sentiment that "insider trading has hurt the interests of retail investors for decades" and "regulators must address the issue to allow the country's capital market to flourish." The CSRC, which previously obtained only one criminal conviction for insider trading in its history, referred fifteen people for criminal prosecution in 2010 and investigated over forty insider trading cases in 2011, imposing ¥335 million in fines and banning eight investors from the market. One of CSRC's criminal prosecutions resulted in a fourteen-year prison sentence, the stiffest in the history of the People's Republic of China. Likewise, Hong Kong issued the most severe sentence for insider trading in 2009: it sent a former Morgan Stanley managing director to prison for seven years and fined him $23.3 million.

In addition to the United States, EU, China, and Hong Kong, developing countries are also cracking down on insider trading. For the first time in its history, Russia made insider trading a criminal offense in 2011. The head of Brazil's Comissão de Valores Mobiliários (Securities and Exchange Commission), Maria Helena Santana, explained that "after having investors consider our legislation and regulatory environment not safe enough or strong enough," she identified the fight against insider trading as her "single most important task." Recent public statements by global market regulators prioritizing insider trading enforcement, coupled with the recent spike in the

21. Id.
22. See Han Shen, A Comparative Study of Insider Trading Regulation Enforcement in the U.S. and China, 9 J. BUS. & SEC. L. 41, 72 (2008) (discussing the singular 2003 criminal case and speculating that there have been a greater number of violations).
27. Tipping the Scales, supra note 2.
28. Id.
number of prosecutions and the severity of penalties, are evidence of a
global effort to eliminate illegal insider trading from world markets.
This Note argues that the recent global crackdown on insider trading is
in response to the Great Recession. It further argues that the
simultaneous attack on insider trading by the major markets of the
world represents a shared perception by leaders around the world that
heightened enforcement of insider trading will benefit their economies.
The globally shared belief is that strong enforcement of insider trading
prohibitions facilitates investment in stock markets by reducing
investor fear. Increased stock market investment promotes capital
market development and, thus, grows the economy.

Before delving into the argument, it is important to understand
what constitutes insider trading, why it is illegal, and how its
prohibition spread around the world. Part I of this Note explains insider
trading through the presentation of a historical analysis of the
development of U.S. insider trading law because it was the first country
to successfully prosecute crime and, thus, prohibit it through common
law. Part II addresses the global development of insider trading laws
by focusing on the enactment of prohibitions on insider trading by the
EU and China. Part III identifies recent measures taken by these
nation-states and the Financial Industry Regulatory Authority

30. While China and the United States are countries and the European Union is not,
they will be categorized together throughout the Part II discussion because the European
Union mandated its member countries to adopt the insider trading legislation in its
Market Abuse Directive. See Thomas C. Pearson, When Hedge Funds Betray A Creditor
Committee's Fiduciary Role: New Twists on Insider Trading in the International Financial
From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading
31. The European Union and China were chosen because, with the inclusion of the
United States, the analysis then includes the world's three largest economies and 60% of
the world's Gross Domestic Product (GDP). The 2010 GDPs (in millions of U.S. dollars) of
the United States ($14,624,184), the European Union ($16,106,896), and China
($5,745,133) represent 60% of the world's GDP ($61,963,429). World Economic Outlook
(last visited Dec. 23, 2011); National Accounts – GDP, EUROSTAT,
(last visited Feb. 12, 2012). It is important to note that China's
aforementioned figures do not include the GDP of Hong Kong or Taiwan. Since both Hong
Kong and Taiwan independently regulate their securities markets, Part III's discussion of
China's securities regulation will not include their securities regulation.
(FINRA)\textsuperscript{32} to enhance the reach of their respective regulatory organizations tasked with policing their securities markets. Lastly, Part IV also presents and analyzes evidence of whether the increase in insider trading enforcement will benefit the global market.\textsuperscript{33}

I. HISTORICAL DEVELOPMENT OF INSIDER TRADING REGULATION

A. What is Insider Trading?

Insider trading is a term subject to a wide variety of definitions, which include both legal and illegal actions.\textsuperscript{34} Legal insider trading occurs everyday when corporate insiders (i.e., officers, directors, or employees) purchase or sell shares of their own companies' stock in accordance with their companies' policies and the laws governing the transactions.\textsuperscript{35} The definition of insider trading discussed by this Note is the illegal trading that takes place when individuals abuse their access to privileged and confidential information by using knowledge about significant developments of a company that impact its stock price to make profits or prevent losses in the stock market.\textsuperscript{36} Significant developments are usually related to earnings and acquisitions; however, information as obscure as the health of a chief executive officer may also trigger the materiality element.\textsuperscript{37}

The definition of illegal insider trading, according to the SEC, is the "buying or selling [of] a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material,

\textsuperscript{32} FINRA is a private, self-regulatory organization that is responsible for surveillance of eighty percent of the trading volume of the U.S. markets, in addition to various global markets (e.g., the NYSE EuroNext group). Press Release, FINRA, FINRA 2010 Year in Review (Dec. 17, 2010), available at http://www.finra.org/Newsroom/NewsReleases/2010/P122662.


\textsuperscript{35} Id.

\textsuperscript{36} See generally Ryan M. Davis, Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability, 63 VAND. L. REV. 1469 (2010).

\textsuperscript{37} See Tom C. W. Lin, Undressing the CEO: Disclosing Private, Material Matters of Public Company Executives, 11 U. PA. J. BUS. L. 383, 283-87 (2009) (using Steve Jobs, the former CEO of Apple Inc., and his health problems to explain the potential for CEO health to become material).
nonpublic information about the security.” However, there are disagreements as to what constitutes “purchase or sale,” “material,” “nonpublic,” and “security.”

B. The Formation and Development of Insider Trading Laws

U.S. courts have played the largest role in defining the laws prohibiting insider trading because laws regulating insider trading first arose largely out of U.S. common law. In accordance with its Congressional mandate to “protect investors and keep [its] markets free from fraud,” however, the SEC has played a key role in shaping U.S. insider trading law. SEC prosecutors, along with their Department of Justice (DOJ) counterparts, choose which suits to bring and which legal arguments to set forth, thus shaping the discussion in the courts. The U.S. prohibition on insider trading has progressed from an extremely broad beginning to an over contraction period, followed by a third re-expansion of the law’s reach.

1. The Origin of Insider Trading Liability

The origins of insider trading prohibitions are found in the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act), which Congress enacted in the wake of the Great Depression in an attempt to control the abuses believed to have contributed to the stock market crash of 1929. Section 16(b) of the 1933 Act addressed insider trading directly by prohibiting “short-swing profits” by corporate insiders trading their own company’s stock. In the 1934 Act, Congress did not address insider trading specifically; rather, Congress afforded broad power to the SEC in Section 10(b) that

38. Insider Trading, supra note 34. The SEC continues: “[i]nsider trading violations may also include ‘tipping’ such information, securities trading by the person ‘tipped,’ and securities trading by those who misappropriate such information.”


40. Newkirk & Robertson, supra note 8.

41. Id.

42. Id.

43. Id.

44. Id.

45. Id.

46. Id. Short-swing profits are defined as any “profits realized in any period less than six months.” Section 16(b) only applies to corporate directors or officers and individuals who hold more than 10% of a company’s stock.
permits the SEC to prosecute individuals other than corporate officers for insider trading.\textsuperscript{47}

Section 10(b) of the 1934 Act addresses insider trading indirectly by prohibiting any person "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, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe."\textsuperscript{48} The SEC's Rule 10b-5, promulgated from Section 10(b), says, in relevant part:

\begin{quote}
It shall be unlawful for any person, directly or indirectly . . . ,

(a) [t]o employ any device, scheme, or artifice to defraud,

(b) [t]o make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sales of a security.\textsuperscript{49}
\end{quote}

While the broad antifraud provisions of Section 10(b) and Rule 10b-5 do not expressly discuss insider trading, they are where the SEC found authority to prosecute individuals for illegal insider trading.\textsuperscript{50} According to the SEC, Section 10(b) and Rule 10b-5 were "relatively easy to apply to the corporate insider who secretly traded in his own company's stock while in possession of inside information because such behavior fit within traditional notions of fraud," but it was "[f]ar less clear" whether they "prohibited insider trading by a corporate 'outsider.'"\textsuperscript{51}

\begin{footnotes}
\footnote{47. Pearson, \textit{supra} note 30, at 192.}
\footnote{48. Newkirk & Robertson, \textit{supra} note 8.}
\footnote{49. SEC Employment of Manipulative and Deceptive Devices Rule, 17 C.F.R. § 240.10b-5 (2009).}
\footnote{50. Newkirk & Robertson, \textit{supra} note 8.}
\footnote{51. \textit{Id.} (emphasis omitted).}
\end{footnotes}
2. Broad Beginnings for Prohibited Insider Trading: The Abstain or Disclose Rule to the Equal Access Theory

It was not until 1961, in *In re Cady Roberts & Co.*, that the SEC first successfully prosecuted an individual for insider trading pursuant to Section 10(b) and Rule 10b-5.52 In *Cady*, the SEC held that the duty or obligations of a corporate insider could be attached to individuals outside the corporation, thus adopting the "disclose or abstain" rule.53 According to the disclose or abstain rule, a corporate insider, or those who are known as "temporary" or "constructive" insiders, must disclose all material nonpublic information known to him before trading, or if disclosure is improper or impracticable, refrain from trading until the information becomes public.54

Several years later, in *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit expanded the reach of the "disclose or abstain" rule established in *Cady*, which only applied to information held by or received from corporate insiders, to a rule that applied to anyone in possession of material, nonpublic information.55 The *Texas Gulf Sulphur* court held that "anyone in possession of material inside information must either disclose it to the investing public, or must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."56 According to the court, no one should be allowed to trade on inside information because it defrauds all other buyers and sellers; fairness in the markets can only be ensured through equal access to information.57 The "equal access theory" established in *Texas Gulf Sulphur* was the broadest form of prohibited insider trading in the United States.58


A decade later, in *Chiarella v. United States*, the U.S. Supreme Court trimmed back the broad scope of prohibited insider trading established in *Texas Gulf Sulphur*.59 In *Chiarella*, the Court reversed

53. Id. at 910-11.
56. Id. (emphasis added).
the lower court's conviction of Vincent Chiarella for insider trading in violation of Section 10(b) and Rule 10b-5.60 Chiarella obtained material, nonpublic information through his capacity as an employee of a printing company that was printing confidential documents pertaining to a corporate acquisition.61 Charges were brought against the printing employee on the theory that he defrauded the shareholders of the target company who sold him their shares.62 The Court held that the printing employee's trades based on material, nonpublic information did not constitute a violation of the 1934 Act's antifraud provisions because he did not owe a fiduciary duty to the target company shareholders who sold him their shares.63

4. Re-expansion of Insider Trading: The Misappropriation Theory

The narrow rule from Chiarella left significant gaps in the prosecution of traders who owed no fiduciary duty to their companies, but obtained and traded on material, nonpublic information.64 One year after the Chiarella decision, the Second Circuit filled the gaps by adopting the "misappropriation theory" in United States v. Newman.65 The Newman court held that a person who owes no fiduciary duty to an issuer of securities may nonetheless be liable under Rule 10b-5 if he trades using material nonpublic information "misappropriated from someone with whom he had a relationship of trust and confidence."66

Over the next decade, the misappropriation theory was accepted by a number of federal jurisdictions;67 but then in 1996, the Eighth

60. Id. at 225.
61. Id. at 224.
62. Id. at 224-25.
63. Id. at 232-35.
64. Davis, supra note 36, at 1478. Similarly, if a typical shareholder obtained material, nonpublic information about a company, he was essentially immune to liability for insider trading. Id.
67. See, e.g., SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984). During this time period the Supreme Court also extended insider trading liability to "tippees." Dirks v. SEC, 463 U.S. 646, 648-49 (1983). According to the Court:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by
Circuit rejected the misappropriation theory in *United States v. O'Hagan*. O'Hagan was an attorney who worked at a law firm representing an acquiring corporation in a tender offer—the target company was Pillsbury Corporation. O'Hagan traded Pillsbury's stock based on the material, nonpublic information he obtained through his employment. Although neither O'Hagan nor his law firm owed a fiduciary or other similar duty to the target company, the U.S. Supreme Court nevertheless overturned the Eighth Circuit, finding him guilty of violating Section 10(b) and Rule 10b-5. The Court held that Section 10(b) does not require the fraudulent nondisclosure to be a breach of a fiduciary duty to either party; rather, the breach can be based on a duty to the source of the information. Since O'Hagan owed a duty to his law firm, which was the source of the information, he was guilty of insider trading. Thus, through the misappropriation theory, the Court again extended the reach of insider trading liability to corporate outsiders who do not owe fiduciary duties to shareholders.

The pendulum of reach from broad to narrow prohibitions on insider trading experienced by the United States is due largely to its formation and development in common law. As the judiciary applied its insider trading precedent in a case-by-case manner, the law was fine-tuned to circumvent the imperfections brought to light by each case.

## II. THE GLOBAL DEVELOPMENT OF INSIDER TRADING LAWS

Prohibitions on insider trading did not emerge in the rest of the world until around the mid- to late-1980s; however, by 1990, only thirty-four nations of the 103 countries with stock exchanges had insider trading regulations. Of those thirty-four countries, only nine had actually prosecuted someone for violating the countries' insider trading

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Id. at 660. In other words, the Court held that an insider breaches his fiduciary duty if he will "benefit, directly or indirectly, from his disclosure" to a third party. *Id.* at 662.
69. *Id.* at 614.
70. *Id.*
72. *Id.* at 659-60.
The later emergence of insider trading laws in the rest of the world permitted countries to analyze the successes and failures of the United States' common law development of its interpretation of prohibited insider trading. As a result, much of the world's insider trading regulation is based on U.S. law. The following sections discuss the formation of insider trading laws in the EU and China.

74. Id.
75. Id. at 65-66.
76. Id. at 65.
77. Id.
A. European Union’s Insider Trading Laws

Historically, EU member states either had less developed stock markets that did not face as much insider trading abuse or they had policies that promoted a “no-questions-asked posture” (e.g., Greece, Italy, and Portugal previously considered insider trading acceptable). However, in 1990, Germany, who had previously opposed EU proposals for prohibiting insider trading, finally recognized “the need for some form of insider trading legislation in order to build a competitive international financial sector.” Accordingly, EU Council Directive 89/592 required member states to pass insider trading legislation that either “met or exceeded” minimum specifications.

The preamble to the Directive made it clear that the Directive’s purpose was to create and build investor confidence. Insiders were identified through either their status or their ability to access information. The Article 2(1) definition of an insider is:

[Alny person who possessed information: (i) by virtue of his membership of the administrative, management or supervisory bodies of the issuer; (ii) by virtue of his holding in the capital of the issuer; or (iii) because he had access to such information by virtue of the exercise of his employment, profession or duties.

In 2003, the EU updated its insider trading laws through its Market Abuse Directive, which provides regulators with a broader definition of “insider dealer,” the term the EU uses for insider trading. An insider deal is now defined as “a qualifying investment or related investment on the basis of inside information relating to the investment in question.”

81. Id. at 54.
82. Id. at 55.
83. Loke, supra note 30, at 142.
84. Id.
85. Id.
87. Loke, supra note 30, at 146 (quoting Financial Services and Markets Act, 2000, S.I. 2005/381, art. 118(2) (U.K.)).
An insider is broadly defined to include managers, shareholders, and professionals who have access to inside information because of their employment, in addition to individuals who obtain inside information through criminal conduct. The Market Abuse Directive definition of insider dealer also covers tippees by including those who can reasonably expect to know that the information they are obtaining is inside information.

The Market Abuse Directive is strikingly similar to U.S. insider trading law and its core provisions are limited to only three pages. One scholar explains:

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, 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 laws.

The simplicity of the EU's three-page Market Abuse Directive allows stock market participants in EU member states to clearly know if their actions are prohibited and, thus, appropriately predict the outcome of litigation.

B. China's Insider Trading Laws

Like the Market Abuse Directive, China's insider trading laws were largely derived from the U.S. prohibition on insider trading. Instead of spending time and resources developing a new regime, China adapted the most effective and efficient regulations and enforcement techniques from the history of U.S. insider trading laws. China's first securities
laws took effect in 1999; however, its current securities regulation statute is the result of a 2006 statutory overhaul.\textsuperscript{94}

China's current securities regulation statute, entitled Securities Laws, includes a general provision, Article 76 (2006), prohibiting any person with access to insider information from using that information to trade securities.\textsuperscript{95} Article 76 contains wording that encompasses theories of insider trading developed in the United States.\textsuperscript{96} The misappropriation theory, endorsed by the U.S. Supreme Court in \textit{O'Hagan},\textsuperscript{97} is visible in the Article 76 requirement that "[a]ny insider who unlawfully obtained inside information on securities trading may not purchase or sell the securities, divulge such information, or advise any other person to purchase or sell such securities."\textsuperscript{98}

Notably, however, China diverged from U.S. insider trading law in that it did not premise its insider trading liability on fiduciary duties\textsuperscript{99}—the U.S. misappropriation theory is premised on the trader owing a fiduciary duty to the source of the information. Instead, China opted to premise its insider trading on the equal access theory, which can be found in the following declaration of Article 76:

\begin{quote}
[P]rior to the public disclosure of inside information, a person who has knowledge of inside information on securities trading or a person who illegally obtains such information cannot purchase or sell such securities, divulge such information, or counsel another to purchase or sell such securities.\textsuperscript{100}
\end{quote}

The United States moved away from the equal access theory, promulgated in \textit{Texas Gulf Sulfur}, after determining its reach was too broad.

China, like the European Union and the United States, prohibits the use of material, nonpublic information by traditional corporate insiders to trade securities, and it extends the liability to individuals


\textsuperscript{95} Shen, \textit{supra} note 22, at 52.

\textsuperscript{96} See id. at 52-53.

\textsuperscript{97} 521 U.S. 642, 659 (1997).

\textsuperscript{98} Shen, \textit{supra} note 22, at 53.

\textsuperscript{99} Id. at 52.

\textsuperscript{100} Id.
who have misappropriated that information. Thus, the global emergence of insider trading laws can be traced to the origin of insider trading laws in U.S. common law prior to becoming statutory law in the EU and China.

III. EVIDENCE OF A GLOBAL “CRACKDOWN” ON INSIDER TRADING

Despite the global emergence of insider trading legislation in the 1990s, few countries actually enforced their laws until recently. This section analyzes recent developments evidencing a global crackdown on insider trading by governments and self-regulatory organizations around the world, focusing on evidence from China, the European Union, the United States, and the Financial Industry Regulatory Authority (FINRA), a private, self-regulatory organization that is responsible for the surveillance of eighty percent of the trading volume of the U.S. markets, in addition to various global markets (e.g., the NYSE EuroNext group).

A. China’s Crackdown on Insider Trading

The global trend of heightened enforcement of insider trading prohibitions may be most visible in China. From 2002 to 2006, the China Securities Regulatory Commission (CSRC) only brought one administrative sanction related to insider trading; however, in 2010, the CSRC investigated fifty insider trading cases, resulting in administrative penalties for nineteen people and three organizations. In 2011, the CSRC investigated over forty insider trading cases, imposing ¥335 million in fines and banning eight investors from the market.

Until 2008, the only criminal conviction for insider trading took place in 2003, in which the codefendants, Ye Huanbao and Gu Jian, were sentenced to prison for three and two years, respectively. However, in 2010, the CSRC referred fifteen people for criminal prosecution. The most prominent case involved Huang Guangyu,
former chairman of the mega Chinese electronics retail corporation Gome, in which the business mogul was sentenced to fourteen years in prison.\textsuperscript{108}

In 2010, the chief of the CSRC, Shang Fulin, confirmed that the government had increased insider trading enforcement in 2010 and said it would continue to "strengthen monitoring and control in efforts to prevent insider trading."\textsuperscript{109} On December 1, 2011, the new chairman of the CSRC had a much more resolute tone: "Here we make a solemn declaration: the CSRC has zero tolerance for insider trading and crimes in the securities and futures markets . . . . We will resolutely crack down on every securities crime we discover."	extsuperscript{110} According to Liu Guanwu, an Initial Public Offering (IPO) analyst with a large Beijing firm, "[i]f the main mission of the former CSRC chairman was to give the securities market more tiers and functions, the new chairman has set a goal of ensuring that it will function more efficiently and smoothly."\textsuperscript{111}

\textbf{B. Europe's Crackdown on Insider Trading}

Like the CSRC, regulators of European stock markets are also enhancing their efforts and resources. For example, the United Kingdom's Financial Services Authority (FSA) has increased its enforcement division staff from 250 employees to 400 employees in the last few years.\textsuperscript{112} Of those 150 new employees, it is reported that a significant number are "specialist staff, lawyers and city grandees."\textsuperscript{113} One partner at a large, private London law firm affirmed the report in saying, "I've noticed a marked increase in [the] quality of the people in enforcement."\textsuperscript{114} The increase in resources and staff has led to quantitative results: in 2009, the FSA fined its financial industry a record £34.8 million\textsuperscript{115} and obtained its first successful criminal conviction for insider trading.\textsuperscript{116}

\textsuperscript{108} Id.

\textsuperscript{109} Insider Trading Crackdown to Continue in China: CSRC, supra note 104.

\textsuperscript{110} Changxin, supra note 20.

\textsuperscript{111} Id.

\textsuperscript{112} Kitching, supra note 13.

\textsuperscript{113} UK Watchdog, supra note 16.

\textsuperscript{114} Id.

\textsuperscript{115} Id.

\textsuperscript{116} Kitching, supra note 13. FSA instituted the criminal proceedings against Christopher McQuoid, a solicitor at TTP Communications, and James Melbourne, McQuoid's father-in-law, for insider trading in January 2008. Id. McQuoid was charged with passing Melbourne inside information about Motorola's takeover of TTP. Id. Melbourne then traded on that information; their convictions came down in March 2009. Id. (citing R. v. McQuoid, [2009] EWCA (Crim) 1301 (Eng.)).
In August 2011, the FSA launched a new multi-million dollar market surveillance system, called Zen. The launch of the Zen system is in accordance with the European Union’s plan, which is termed the Market in Financial Instruments Directive (MiFID), to synthesize all member state’s market abuse surveillance systems. To further arm the agencies tasked with policing its securities markets the EU unveiled two new directives on October 20, 2011—Markets in Financial Instruments Directive (MIFID II) and Market Abuse and Criminal Sanctions—to “reinforce the investigative and sanctioning powers of regulators” and to “ensure minimum criminal sanctions for insider dealing and market manipulation.” The European Union’s Internal Market and Services Commissioner Michel Barnier said:

Sanctions for market abuse today are too divergent and lack the necessary deterrent effect. By imposing criminal sanctions for serious market abuse throughout the EU we send a clear message to deter potential offenders—if you commit insider dealing or market manipulation you face jail and criminal record. These proposals will heighten market integrity, promote investor confidence and level the playing field in the internal market.

C. United States’ Crackdown on Insider Trading

In the past two years, U.S. investigators began to use more invasive and sophisticated techniques, such as multi-year wiretaps and plea-bargaining with informants, historically only used in murder and drug conspiracies, to crack down on insider trading. These tactics were highly scrutinized in the case of Raj Rajaratnam. Rajaratnam’s

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118. Id.
120. “Insider dealing,” or what the European Union calls insider trading, “occurs when a person who has price-sensitive inside information trades in related financial instruments.” European Commission Seeks Criminal Sanctions for Insider Dealing and Market Manipulation to Improve Deterrence and Market Integrity, supra note 18.
121. Id.
123. Id.
defense team in both his civil and criminal cases objected to the admission of the wiretaps; however, the evidence was ultimately admitted. According to Preet Bharara, the U.S. Attorney who criminally prosecuted Rajaratnam and his codefendants, the case was the “first time that court-authorized wiretaps have been used to target significant insider trading on Wall Street,” and all the defendants charged with insider trading “were ultimately caught committing their alleged crimes over phones that [law enforcement was] listening to.”

In addition to the new invasive and sophisticated investigative techniques, U.S. politicians have taken steps to equip market regulators with more resources. The 2010 U.S. Congress passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Wall Street Journal described the Dodd-Frank Act as “the biggest expansion of government power over banking and markets since the Depression.” Among other things, the Dodd-Frank Act provides the SEC with heightened authority by authorizing it to create a specific whistleblower bounty program, enhancing its subpoena powers, authorizing it to share information with other federal government agencies (e.g., Department of Justice, Federal Bureau of Investigation, and Public Accounting Oversight Board), expanding its enforcement authority over previously unregulated or lightly regulated areas (e.g., hedge funds, derivative professionals, and investment advisors), and enhancing its ability to streamline enforcement.

One example of streamlined enforcement is the Financial Fraud Enforcement Task Force (Task Force), which is authorized with an annual budget of $245 million and comprised of officials from more than twenty-five separate government agencies, including the Department of

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124. Id.
125. Id.
130. It is important to note that the task force was formed in response to Congress passing the Fraud Enforcement Act, not the Dodd-Frank Act. The Financial Enforcement Act is yet another example of the many steps taken by Congress to ramp up enforcement of U.S. securities regulation.
Justice, Treasury Department, and the Securities and Exchange Commission. The U.S. Attorney General, Eric Holder, the chair of the Task Force, said the Task Force “will wage an aggressive, coordinated, and proactive effort to investigate and prosecute financial crimes.” The Task Force has placed the highest priority on securities fraud, including insider trading and mortgage fraud. According to Holder, the Task Force is designed “to prevent another [financial] meltdown from happening.”

D. FINRA’s Crackdown on Insider Trading

In addition to the evidence of a global crackdown on insider trading by nation-states, self-regulatory organizations are also increasingly active in detecting illegal insider trading. For example, FINRA markedly increased its focus on insider trading in recent years. In 2010, FINRA launched the Office of Fraud Detection and Market Intelligence (OFDMI) to investigate and refer potential fraudulent matters, with a focus on insider trading and Ponzi schemes, to the SEC or federal law enforcement agencies. In 2010, FINRA referred 244 insider-trading cases to the SEC, the highest in the history of FINRA.

As can be seen by the increase in enforcement by nation-states and self-regulatory organizations from around the world, there has been a rampant increase in the enforcement of insider trading regulation in the wake of the Great Recession.

IV. WILL THE INCREASED ENFORCEMENT OF INSIDER TRADING LAWS BENEFIT ECONOMIES?

The main goal of prohibiting certain forms of insider trading is to increase the integrity of the market by deterring people from partaking in unfair activity, which in turn makes it more desirable to invest in the market, which in turn makes capital more affordable, and which in turn leads to economic growth.
The possibility of executing trades with someone who has inside information makes investing riskier for those investors without inside information. If an investment is riskier, then it will be worth less to a rationale investor. Thus, investors without inside information will not offer as high of prices in a market where some investors have inside information.\(^\text{139}\) This decrease in price leads to a decrease in available capital, which reduces the potential for economic growth.

In addition, investors without inside information will be less likely to invest in a market where there is a heightened risk of trading with an individual who has more information.\(^\text{140}\) In other words, an absence of a prohibition on insider trading creates a disincentive for people to invest.\(^\text{141}\) A decrease in investors would result in a decrease in investment, which means less capital is available.\(^\text{142}\) If there is less capital, the cost of capital will rise, which, in turn, will stunt economic growth.\(^\text{143}\)

An empirical study sought to examine the direct effect of insider trading laws on securities markets by analyzing if insider trading laws in fact decrease the cost of raising capital.\(^\text{144}\) Specifically, the study analyzed whether the existence or the enforcement of insider trading laws significantly affected the cost of raising capital through the issuance of securities, or equity, on stock exchanges.\(^\text{145}\) The study calculated the cost of equity through the average realized monthly return on the main stock market of 103 countries.\(^\text{146}\) After the study controlled for differences in liquidity, exchange-rate risk, the global integration of the market, and other shareholder-protection laws, the existence of an insider trading prohibition did not significantly affect the cost of raising equity.\(^\text{147}\)

However, the cost of raising equity in countries that had prosecuted at least one person for violation of insider trading was significantly lower.\(^\text{148}\) In fact, enforcing insider trading laws decreased the cost of equity.

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142. See Prentice, supra note 140, at 825.
143. Id.
144. See Bhattacharya & Daouk, supra note 78, at 79-104.
146. Id.
147. Id.
148. Id.
THE GLOBAL CRACKDOWN ON INSIDER TRADING

equity by five percent. While five percent does not seem like a significant figure, five percent of the world's stock market capitalization is roughly $1.75 trillion.

Since enforcement of insider trading regulations leads to a decrease in the cost of capital, and a decrease in the cost of capital leads to economic growth, the global crackdown on insider trading promotes economic growth.

CONCLUSION

Over the last few years, there has been a global crackdown on insider trading. The heightened focus on insider trading is evident from statistics showing surges in prosecutions and record fines. Moreover, governments have enhanced enforcement through measures broadening the powers and resources of their financial regulatory organizations. There has also been a marked increase in insider trading enforcement by FINRA, a private, self-regulatory organization that polices eighty percent of the securities traded in the United States. From North America to Europe to Asia, the heightened enforcement of insider trading is taking place in countries around the world.

The sweeping focus on insider trading came in the wake of the Great Recession, or the global financial crisis that erupted in 2007. Is the global crackdown on insider trading representative of a good-faith belief by market regulators that insider trading is actually harmful to the capital markets? Or does the spike in enforcement of insider trading regulation serve some other end?

The recent heightened enforcement of insider trading may merely represent government officials and market regulators looking for someone (i.e., Wall Street insiders) to blame for the financial crisis. In times of financial turmoil, publicity tends to focus on the great wealth of those in the financial industry, thus making them logical targets for the blame. However, China's heightened enforcement foils this theory. China was able to maintain a nine percent growth in its economy both in 2008 and 2009, and, in mid-2010, it overtook Japan as the world's second largest economy. Thus, the Chinese government did not need anyone to blame.

149. Id.
150. Id.
It is also possible that government officials are using the financial crisis as an opportunity to pass financial reform, which strengthens the power of the federal government and may be unpopular in strong economic times. This conclusion, however, does not resolve the increase of enforcement in China because it is a communist government; thus, broadening the reach of the federal government is not one of China's concerns.

Another conceivable explanation is that financial desperation during the tough economic times has led to an increase in the prevalence of insider trading. Given the vast escalation of prosecutions, however, this also seems unlikely. In particular, an increase in illegal insider trading activity does not explain why a number of countries handed down their first criminal convictions for insider trading violations in the past few years.

Since the other possibilities fail to explain the dramatic increase in enforcement of insider trading laws, the global crackdown may truly be representative of a good-faith belief by leaders around the world that insider trading is harmful to the capital markets. The global emphasis on insider trading likely took form out of a shared belief among market regulators that insider trading impedes market development, or, alternatively, the presence of a strong enforcement of insider trading creates confidence in the markets and in turn spurs economic growth. Regardless, the trending increase in insider trading enforcement represents a consensus among capital markets across the world that the prohibition and deterrence of insider trading is beneficial to the economy during financial crises. Strong enforcement of insider trading prohibitions benefit the economy through their facilitation of investment in stock markets, which promotes capital market development and enables economic growth.