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Cross-Border Insider Trading

Donald C. Langevoort*

Some forty years have now passed since the United States Securities and Exchange Commission (SEC) began seriously to attack the problem of insider trading in its seminal *Cady, Roberts* decision.¹ Since then, a complex pattern of regulation has evolved, largely through a common law process of judicial interpretation of the open-ended antifraud provision of the federal securities laws, Rule 10b-5. While many interpretive questions still remain open, U.S. law in this area broadly prohibits trading based on material nonpublic information when:

- (1) the trader directly or indirectly owes a fiduciary duty to marketplace traders on the other side of the transaction;²
- (2) the trader has misappropriated the information from a source to which he owes some kind of fiduciary duty;³ or
- (3) the trader possesses tender-offer related information derived from either the bidder or the target.⁴

These prohibitions on trading carry with them a corresponding duty to refrain from “tipping” others. If this is violated, the “tippee” can be held liable as a co-venturer with the tipper/insider.⁵

As far back as the early 1980’s, the SEC began to act against instances of cross-border insider trading: situations where the pattern of trading involved some conduct outside the United

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1. See *In re Cady, Roberts & Co.*, 40 SEC 907 (1961); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319 (1999). Before *Cady, Roberts*, only Section 16 of the Securities Exchange Act of 1934 sought to address the insider trading problem, and it was substantially limited in scope.

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

3. *United States v. O’Hagan*, 521 U.S. 642 (1997).

4. Securities Exchange Act of 1934, 15 U.S.C. § 78, Rule 14e-3.

5. *Dirks v. SEC*, 463 U.S. 646 (1983). The test used in *Dirks* is (1) whether the insider was breaching a fiduciary duty by seeking a personal benefit via the tipping and (2) whether the tippee knew or had reason to know of the breach. Whether this awkward test applies in misappropriation cases is open to debate.

States.⁶ In a number of such cases, foreign persons used foreign brokerage accounts to trade in the securities of multi-national companies on the New York Stock Exchange or NASDAQ. In 1999, for example, the SEC brought a case involving trading by an Italian portfolio manager through the Swiss office of a brokerage firm in the stock of a Netherlands corporation that was the subject of a takeover bid by a Swiss company.⁷ The incidence of cross-border insider trading cases is, of course, what led the SEC to begin to negotiate memoranda of understanding with various countries to facilitate their investigation.

We are seeing an increasing stream of such cases. That should not be surprising in light of the increasing globalization of the securities markets and the rapid increase in the number of cross-border mergers and acquisitions—the setting in which the largest insider trading temptation exists.⁸ As persons from various countries become involved in the confidential negotiation or planning of such deals, the locus of insider trading problems spreads.

Currently, there is no formal SEC policy on when U.S. insider trading rules (or indeed Rule 10b-5 generally) will be applied extraterritorially. If one can glean anything from SEC action during the last twenty years, it is that the trading site—the use of U.S. market mechanisms—that counts most.⁹ Certainly, neither the trader nor the issuer need be U.S.-based. What I wish to do in this paper is articulate what I think is sensible enforcement policy for a nation—whether the U.S. or any other—to adopt. By this, I do not want to focus on the question of the extent of a country's *jurisdiction* to prescribe in accordance with the dictates of

6. See SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (1981); Pitt, Hardison & Shapiro, *Problems of Enforcement in the Multinational Securities Markets*, 9 U. PA. J. INT'L BUS. L. 375 (1987).

7. SEC v. Euro Security Fund, [1999 Tr. Binder] FED. SEC. L. REP. (CCH) par. 90,433 (S.D.N.Y. 1999). The trading was on the New York Stock Exchange, and the principal office of the brokerage firm used to execute the trades was in New York.

8. See Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany and Australia*, 66 U. CINN. L. REV. 1133 (1998).

9. The fact that shares of the company in question are traded in the U.S. means both that domestic market mechanisms are being abused. Presumably, U.S. interest on these grounds could also come from the fact that there is substantial U.S. investor interest and ownership of shares traded on domestic markets. The 1989 EC Directive on Insider Trading is similarly vague, although it clearly confers jurisdiction on the country where the trading occurred.

international law.¹⁰ Familiar principles of international law give immense scope to jurisdiction, permitting enforcement either when conduct in question occurs in substantial part in the regulating country or has significant effects in that country. But clearly, either through prosecutorial restraint or judicial limitation, a nation can choose to give lesser scope as a matter of prudence, comity and the wise expenditure of limited investigatory resources.¹¹

This is an issue that all sophisticated capital marketplace nations ought think through. But I recognize that at present, at least, the U.S. is the most likely nation to act extraterritorially, even when insider trading laws exist in the other nations involved. Four things tempt a country like the U.S. to extend its insider trading jurisdiction. First, conduct might be unlawful domestically, but not unlawful in the country to which the jurisdictional reach is directed. This is possible, though in light of the rapid evolution of insider trading laws throughout the world, not necessarily likely.¹² Second—and more likely—it is conceivable that the action might be unlawful where it occurred, but the local authorities do not seem likely to take action against it. One of the most obviously, and troubling, phenomena in international securities regulation is that even as the “law on the books” in most developed countries converges on a common model, the commitment of surveillance and enforcement resources varies considerably.¹³ It remains primitive in many nations—perhaps deliberately so. Third, even if local authorities take an interest, their enforcement tools may not

10. I have addressed this elsewhere. See Donald C. Langevoort, Schoenbaum Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Market, 55 LAW & CONTEMP. PROB., no. 4, at 241 (1992).

11. By and large, the courts have not pruned the extraterritorial scope of the law to incorporate comity limits, though they could do so. For a call in this direction, see *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 148 (D.C. Cir. 1984).

12. So far as the U.S. is concerned, its law may actually be more restricted than that in certain other countries that have addressed the problem via comprehensive statutory reform, such as Australia. See James Cox, *An Outsider's Perspective of Insider Trading Regulation in Australia*, 12 SYDNEY L. REV. 455 (1990). Because U.S. law takes something of a common law form, it is difficult to state with precision what it covers and what it does not.

13. See Barry Rider, *Policing the International Financial Markets: An English Perspective*, 16 BROOK. J. INT'L L. 179 (1990). Obviously, politics plays an important role. E.g., *Resignation of Enforcement Staff Throws Stock Exchange into Crisis*, 6 WORLD SEC. L. REP. (BNA) no. 3, at 24 (Mar. 2000) (surveillance staff at Philippine Stock Exchange resigns to protest political interference with insider trading case). For an empirical demonstration of the importance of active enforcement as opposed to mere law-adoption, see Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading* (unpublished manuscript, Indiana University) (2000) (showing that positive stock price effects of insider trading regulation come upon enforcement, not adoption of the rules).

be up to the task.¹⁴ Most countries still use criminal law as their primary weapon against insider trading, creating prosecutorial difficulties in complex cases based largely on circumstantial evidence. Countries that use civil remedies (like the U.S.) may be able to sanction conduct that even their willing regulatory brethren cannot. Finally, the decision to extend jurisdiction might simply be a matter of enforcement efficiency: in a complicated case touching on multiple countries, having one regulator exercise primary jurisdiction over all the related conduct, no matter where it occurred, may be the least costly form of proceeding.¹⁵

I. National Interests at Stake in Insider Trading Regulation

When an insider trading case has a multi-national dimension, there are four major pieces of information needed to assess a claim of appropriate jurisdiction.¹⁶ The first is the nationalities of the traders, as well as the tippers when there was some improper dissemination of the information leading to trading. The second is the nationality of the issuer.¹⁷ Third, we need to know where the information was obtained (i.e., where the source of the information was located). Last, we need to know where the trading occurred—what market mechanisms were used?¹⁸ Where the answers to most of those questions are a single country, the case for claiming jurisdiction is easy. When the answers are scattered, it is harder.

Obviously, there are many possible permutations. To focus the analysis, I will pose a single hypothetical case. Imagine that a British company is negotiating to acquire a Brazilian company. An attorney whose firm in London is advising the acquiring company on certain aspects of the transaction tips a friend in Sweden. The Swedish friend purchases securities in the Brazilian company on the New York Stock Exchange. Here we have four countries whose

14. See Markus Kroll & Rahel Gimmel, *Acquittal in Insider Trading Case Reinforces Concerns About Rules*, 6 WORLD SEC. L. REP. (BNA), no. 2, at 8 (Feb. 2000) (expressing doubts about effectiveness of Swiss law).

15. Similarly, once an investigation has begun that involves largely domestic activity, the discovery of some foreign element brings an almost irresistible temptation to pursue the one trading overseas.

16. For other efforts to work through this problem, whether as a matter of law or policy, see Merritt Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?*, 55 LAW & CONTEMP. PROB., no. 4, at 263 (1992); Ronald E. Bornstein & N. Elaine Dugger, *International Regulation of Insider Trading*, 1987 COLUM. BUS. L. REV. 375.

17. Here, we might consider both the site of its incorporation and its principal place of business.

18. That is, what exchange or trading system was the trade executed on, and what broker-dealers or other intermediary was used to execute it.

interests are at stake; the question is whose interests are strongest, and why.

To address this, it is necessary to think first about why insider trading is regulated in the first place. Indeed, one reason for going through this exercise, apart from its practical importance in our global economy, is that it forces some rigorous inquiry into a question that is rarely thought about very hard outside the academic community. In the United States, the gradual strengthening of the prohibition against insider trading, and the devotion of a good bit of enforcement resources to combating it, has been as much a form of cultural expression as economic regulation. That is not to say that there are not good functional reasons to ban the most abusive forms of insider trading. As we shall see, there probably are. But the issue in the U.S. has a symbolic, indeed almost mythic, character.¹⁹ The ban on insider trading is a highly salient statement about the subordinate place of insider-fiduciaries (and their friends and associates) vis-à-vis the trading public. It flips the hierarchy—the power of economic elites—that otherwise appears to dominate. In this sense, it is a “brand” message to advertise the openness of the American securities markets to public investors by creating the image these investor interests are paramount. It would be presumptuous of me to say whether insider trading regulation in other countries plays the same rhetorical role.²⁰ I would at least venture a guess that many countries have simply (and without deep thought) mimicked the U.S.²¹ system of regulation in their own brand-building efforts to create domestic securities markets of reasonable depth and liquidity, without giving that much thought as to why.

II. The Rationales for Insider Trading Regulation

The academic debate over the regulation of insider trading has had a long and fascinating intellectual history. Initially, the

19. See Langevoort, *Rereading Cady, Roberts*, *supra* note 1, at 1328-31.

20. In a recent article, Barry Rider complains that Great Britain has not thought through its reasons for insider trading regulation and enforcement all that well either. See Barry A.K. Rider, *The Control of Insider Trading: Smoke and Mirrors!*, 1 INT'L & COMP. CORP. L.J. 271 (1999).

21. The U.S. is not alone, of course. In terms of chronology, France was the other major capital marketplace nation to address insider trading in the 1960's. See James Lightburn, *Insider Trading in France*, 7 INT'L FIN. L. REV. 23 (Jan. 1988). Canada (in the Province of Ontario) and Australia also took significant and influential statutory steps toward regulation during that decade. See Stephen Herne, *Inside Information: Definitions in Australia, Canada, the U.K. and the U.S.*, 8 J. COMP. BUS. & CAP. MKT. L. 1 (1986).

appropriateness of the ban in the U.S. was simply taken as a political given; little thought was given to the “why” question. Indeed, the genesis of modern insider trading regulation in the U.S. began when a law professor, William Cary, was appointed chairman of the SEC in 1961.²² His decision to federalize the law of insider trading was explicitly based on a desire to superimpose a strong fiduciary ethic on the U.S. stock markets, to distinguish them from the elites-dominated markets in other countries. By the late 1960’s, however, an intellectual counter-attack was mounted against insider trading prohibition. It was led by Henry Manne, whose influence is still felt today.²³ Through the early 1980’s, academics increasingly doubted whether insider trading regulation was worth the effort, if not outright dysfunctional.²⁴ But in the 1980’s, there was a noticeable turn-around, as more and more economics-oriented scholars began to identify reasons to favor some sort of regulation.²⁵ Today, the balance of sophisticated legal commentary is in favor of insider trading regulation, though even among its supporters there remains vigorous debate over exactly what scope and form the regulation should take.²⁶

The standard explanations for a ban on insider trading fall into two main categories.

A. *Investor Protection*

The first, and most conventional, is investor protection. The initial focus here was on the harm to contemporaneous marketplace traders who sold to or bought from the insider at an informational disadvantage. These appear to be the most visible persons exploited by the insider. This argument has long been seen as

22. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (2d ed. 1995).

23. See HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). For a recent celebration of Manne’s contributions, see *Symposium: The Legacy of Henry G. Manne—Pioneer in Law & Economics and Innovation in Legal Education*, 50 CASE W. RES. L. REV. (1999).

24. E.g., Michael Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980).

25. A key step here was the work of perhaps the most influential conservative law and economics scholar, Frank Easterbrook. See Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309.

26. See Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1620 (1999). For a collection and analysis of the full range of arguments, see James D. Cox, *Insider Trading and Contracting: A Reply to the Chicago School*, 1986 DUKE L.J. 628.

weak, however, in light of the workings of modern securities markets. Except in rare circumstances, these traders were not induced into the market by the insider, nor did they rely on any information generated by the insider. They independently entered their buy/sell orders, taking the foreseeable risk that there was some undisclosed information that might make their trade unprofitable. In other words, there is no real causation or reliance of the sort that would suggest fraud. Careful study of the market impact of insider trading has led to the conclusion that so far as contemporaneous traders are concerned, the most plausible story of harm that can be told is that the insiders might crowd out other persons on the same side of the transaction who might have bought or sold at a somewhat more favorable price.²⁷

The inquiry has thus shifted to a revised statement of the problem: how do traders respond *ex ante* to the risk that there may be insiders in the market with an access-based informational advantage? Here, we can see one group of persons who are adversely affected—specialists and marketmakers whose constant buy/sell activity essentially forces them to internalize the risk that some who seek to trade with them have an informational advantage.²⁸ The rational response of the professional trader is to widen the bid-ask spread so as to incorporate a risk premium. This, in turn, has a spillover adverse effect on others who trade with them, by delivering inferior pricing. If this argument is right, as many financial economists argue, then we do have a rationale for regulation so long as the costs of enforcement are less than the gains in terms of reduced spreads.²⁹ A recent Indiana University study, for example, estimates the average cost of capital benefit of *enforced* insider trading regulation for nations that have recently become insider trading regulators at approximately 5%, a statistically significant figure.³⁰

What about the *ex ante* behavior of public investors? Will they either withdraw from the market for fear of insider trading, reducing its depth and liquidity? The economic argument here is

27. See William Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 SO. CAL. L. REV. 1217 (1981).

28. See Lawrence R. Glosten, *Insider Trading, Liquidity and the Role of Monopoly Specialists*, 62 J. BUS. 211 (1989). See also Nicholas Georgakopoulos, *Insider Trading as a Transaction Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993).

29. On enforcement in this context, see Paul Demarzo et al., *The Optimal Enforcement of Insider Trading Regulations*, 106 J. POL. ECON. 602 (1998).

30. Bhattacharya & Daouk, *supra* note 13.

quite complex, but there is little affirmative support for the idea of anything near complete withdrawal, even though any impact on the cost of equity will presumably affect demand to some extent. The Indiana University study gives a 5% figure for the impact of enforced regulation, reflecting the average market price effect of the first prosecution. To be sure, a more sustained pattern of enforcement might well raise the number by some unknown amount. Nonetheless, I suspect that the ultimate figure would not be that much higher.

To me, the real question that investors face is not insider trading standing alone but rather the quality of regulation (or market forces) that cause issuers to publicize information fairly promptly. In a world that reliably forces prompt public disclosure through either legal regulation or market discipline, the risk faced by traders because of the possible presence of insider trading should be limited.³¹ Severe concern about insider trading should occur largely in environments of very low transparency, and on close inspection, it is the lack of transparency, far more than the insider activity, that should drive the regulatory response.

Yet concern about “investor confidence” in the face of insider trading remains, in the U.S. at least, the express motivation behind an aggressive system of regulation—even in a setting of high transparency. This rhetoric, which has become at times almost a moral crusade, echoes repeatedly in the cases running from *Cady, Roberts* in 1961 through the Supreme Court’s most recent endorsement of expansive insider trading regulation in *United States v. O’Hagan*.³² As I suggested earlier, I think the idea that insider trading regulation is necessary to retain the confidence of public investors in the American markets something more of a “brand slogan” than a well-grounded empirical prediction.

But still, this does not mean that it is an unjustifiable regulatory step. First, there remains the technical connection between the interests of public investors and stock price spreads, which are affected by the adverse selection risks of insider trading. My only critical point was that it is hard to ground the aggressive kind of insider trading regulation one finds in the U.S. at this level of subtlety. A 5% (or even 10%) effect on cost of capital justifies intervention, even if it does not warrant a moral crusade. Second,

31. The close connection between mandatory disclosure and insider trading is well illustrated by the SEC’s recent proposal for Regulation FD, which would demand prompt public disclosure anytime there was intentional or inadvertent selective disclosure to a favored investor or analyst.

32. *O’Hagan*, 521 U.S. 642.

investors may actually respond in various ways to myths and symbols, beyond the rational content of the underlying message.³³ Insider trading regulation may be good advertising and public relations, whatever the discrete economic benefits it delivers.³⁴ In the end, this latter point may well be the best descriptive explanation of the rationale behind the U.S. system so far as investor protection is concerned.

B. Corporate Law

The foregoing argument actually splits academics interested in the law and finance. Many are uncomfortable with the “brand” argument as too soft to work in the rational world of investing—or if they are not believers in market rationality, too far removed from the emotions that really moves public investors: greed, herd instincts and so forth. As to the bid-ask spread argument, the question of whether costly and inevitably imperfect enforcement can *efficiently* deliver lower spreads is debated.³⁵

Nevertheless, many such scholars come to support regulation for a separate reason, namely, that it is the *issuer's* best interests to do so. A regime in which insider trading is permissible poses a number of problems from a corporate law perspective. First (and probably foremost), insider trading can compromise the confidentiality of sensitive information that is privileged from mandatory disclosure,³⁶ such as the existence of preliminary merger negotiations. Efforts at secrecy can be broken when unusual stock price trading has occurred in advance of any announcement,

33. Obviously, this question is closely related to the debate over market efficiency. See Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992). I do not want to make the strong claim that an insider trading ban is a *necessary* symbol, but rather an *effective* one for encouraging public investment generally. See Langevoort, *Rereading Cady, Roberts*, *supra* note 1.

34. On the difficult balancing problems, see Khanna et al., *Insider Trading, Outside Search and Resource Allocation: Why Firms and Society May Disagree on Insider Trading Restrictions*, 7 REV. FIN. STUD. 575 (1994). Beyond the public interest arguments, one can also claim that insider trading prohibitions work to the private pecuniary benefit of some large investors. See David Haddock & Jonathan Macey, *A Coasian Model of Insider Trading Regulation*, 80 NW. U. L. REV. 1449 (1987).

35. This is an important point—insider trading enforcement is very costly, especially if a jurisdiction wants to pursue a large portion of suspicious trades. For a criticism emphasizing this cost of insider trading regulation and enforcement, see Dooley, *supra* note 24.

36. See Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEG. STUD. 801 (1980).

exposing the issuer to intense press, market and regulatory scrutiny. Second, confidential information is a valuable form of corporate property.³⁷ Allowing insiders to profit from it a form of waste—irrational from the issuer's perspective unless there is a discrete trade off for a lowered salary.³⁸ Third, permitting insider trading gives key executives an incentive to create volatility in the company's stock price, since they can profit from downswings as well as upswings. From these points, we might predict that rational issuers would seek to bar insider trading if they could.³⁹

Two further points connect the foregoing to more traditional concerns of investor protection. One is that permitting insider trading gives company officials an incentive to delay the release of information to the markets for longer than the business needs of the company would suggest. Thus, there is a linkage between insider trading regulation and the quality of the disclosure regime.⁴⁰ The other goes back to *ex ante* reputation. If marketplace traders (professional or otherwise) fear insider trading, they will demand a risk premium, reflected in a lower stock price. In contrast, the issuer's cost of capital improves as the risk premium diminishes. This is simply the mirror image of the investor-protection point made earlier.⁴¹

III. Connecting National Jurisdiction to Investor and Corporate Interests

With the foregoing in mind, our task now is to decide which of the four countries in our hypothetical—Sweden, Britain, Brazil, or the U.S.—have good grounds to assert jurisdiction over the trading in question. On the assumption that it is quite costly to devote

37. This point is emphasized in Judge Winter's opinion in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

38. See ROBERT CLARK, *CORPORATE LAW* 274-75 (1986).

39. One question posed by critics of regulation is why don't they on their own. See Dennis Carlton & Daniel Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983). One answer seems to be that they lack the surveillance capacity to make such a private prohibition stick. In other words, there is a public goods character to market surveillance.

40. See Robert Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

41. In addition to these points, Merritt Fox has made the forceful argument that insider trading prohibitions are appropriate as a control on agency costs, which is important no so much in the name of investor or corporate protection but because of the compelling regulatory interest in a fair system of allocating capital and other economic resources among the various issuers in an economy. See Fox, *supra* note 16; see also Merritt Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498 (1997).

enforcement resources to the detection and prosecution of insider trading, we should also look fairly closely at the extent to which there will be domestic benefits that exceed the costs. Following standard economic analysis, if the benefits of regulation spill over to other countries without a comparable regime of cost-sharing, we would expect enforcement to occur with less frequency than is optimal (the classic externalities and “free rider” problem).⁴² In this sense, finding the best enforcer is really one of finding which country benefits the most in terms of domestic economic policy from the enforcement.⁴³

A. Sweden: *The Trader’s Homeland*

None of the interests described above justify any strong claim of Swedish jurisdiction. Neither its investors nor its companies are involved (if there are Swedish investors in the Brazilian corporation, it is by happenstance, and gives Sweden no greater interest than any other country whose investors own shares in that issuer). The only possible linkage might be that Sweden believes that its reputation in the world of investing might be tarnished by the impression that it acts as a “Barbary Coast” for securities pirates. In fact, in the U.S. that concern alone is sometimes invoked to justify the exercise of jurisdiction as a legal matter.⁴⁴ The U.S. applies the securities laws to domestic conduct sufficient to state a claim under Rule 10b-5 even when all of the harm is abroad. While there may be some cases where that is a form of good citizenship in the world of securities regulation, my sense is that the claim is fairly

42. For a study of the game theoretic problems of international securities regulation flowing from the jurisdictional mismatch of costs and benefits, with special attention to insider trading, see Amir Licht, *Games Commissions Play: 2x2 Games of International Securities Regulation*, 24 YALE J. INT’L L. 61, 114-25 (1999); Amir Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT’L L. 563 (1998).

43. One might properly ask whether jurisdiction should properly belong to any country whose investors were trading “on the other side” of the insider. Indeed, the U.S. and some other countries engage in the presumption that it is the “contemporaneous traders” who are the victims of the insider. However, a few points about this deserve emphasis. First, there is a fictional element to it: the contemporaneous traders are probably not really the victims of anything resembling fraud. Second, to the extent one wants to take this into account, it will probably be subsumed in the interests of the country of residency—that country will in all likelihood be the one with the greatest number of investors. To the extent that we say that any country with a significant number of contemporaneous traders should bring suit, the possibility for duplication and conflict is severe.

44. See *United States v. Kasser*, 548 F.2d 109, 110 (3d Cir. 1977); *AVC Nederland B.V. v. Atrium Inv. Part.*, 740 F.2d 148 (2d Cir. 1984).

weak in the insider trading context—especially if one of the other countries is willing and able to prosecute. Sweden might owe some other country a duty of regulatory cooperation in the latter country's investigation of the trading, but that strikes me as the extent of its appropriate involvement.

B. Britain: The Source Country

Britain has two interests in the problem at hand: it is home of the tipper and of the acquiring company. It is also the place where a theft of confidential information occurred. Simply from an efficiency perspective, most of the initial investigatory work that would have to be done in the case would be concentrated in Britain, because the circumstances surrounding the obtaining and subsequent use of the information tends to be the heart of an insider trading case.

Britain clearly has good cause to prosecute on some grounds. We have a case of theft of information by a fiduciary, which alone justifies jurisdiction. But the question is whether enforcement on that basis is tied to any element of *securities regulation*. To be sure, the situation described here is a standard “misappropriation” case. The U.S. Supreme Court, in the *O'Hagan* decision, squarely held that Rule 10b-5 is violated when a person defrauds the source of the information by secretly lining his pockets via insider trading while pretending to be a loyal fiduciary. In the Court's eyes, the victims were both the acquiring company (which, by the way, was a British entity) and the trader's employer, a Minneapolis law firm that had been retained by the acquiror. Following this logic, there would seem to be a compelling case for jurisdiction whenever the sources of the information are domestic—even if the trading occurs abroad. Indeed, I would predict that the SEC would bring this case under Rule 10b-5 were it in Britain's shoes. But should it? My sense is that a careful reading of *O'Hagan* indicates that even though the victims were the sources of the information, the justification for regulation under the securities laws was that allowing trading profits based on misappropriated information threatens the integrity of the trading markets.⁴⁵ In *O'Hagan*, all the trading was domestic: the issuer, Pillsbury, was a Minneapolis-based multinational. If that is the message of the decision, there would be no cause to claim jurisdiction as a matter of securities regulation

45. This point was made fairly explicitly by Justice Ginsburg. See *O'Hagen*, *supra* note 3.

absent some tie to the domestic markets. Moreover, because the acquiror is not the issuer, many of the reasons for limiting trading by insiders of the issuer (disclosure incentives, volatility incentives, etc.) simply do not apply to provide “corporate” justifications for regulation.

Still, Britain might be able to make a sound reputational argument in a case like this. The reputation of the acquiring company within the investment community is a matter in which Britain could legitimately take an interest under the rubric of securities law. Even stronger would be its interest in the reputation for probity of the many players (investment banks, law firms, accounting firms and the like) who facilitate merger and acquisition transactions and other forms of securities activities in Britain. Building a financial infrastructure that has a brand image of honesty and loyalty is key for any nation seeking a significant role in the world’s capital marketplace.

C. Brazil: Home of the Issuer

To be sure, Brazil’s interest here is less than it would be if the leak or tip took place through the issuer’s own activities, but it is still substantial. Most importantly, Brazil has an interest in the capital marketplace reputation of its companies for controlling agency costs sufficiently well that investors can take equity positions with reasonable confidence. This, in turn, serves its interest in allocative efficiency as well.⁴⁶ True, here the issuer has done nothing that could possibly have compromised its reputation. But *ex ante*, it is the risk of information exploitation (from whatever source) that investors react to, and thus Brazil’s interest extends to the full range of abuses. We can add to this the prediction—perhaps true on average today, though diminishing gradually—that the largest percentage of investors in the Brazilian corporation are Brazilians themselves, giving Brazil the greatest claim to the extent that the rhetoric of protecting the person on the other side of the trade continues to prevail.

Obviously, if the tip had come from within the Brazilian company, as in the typical insider trading case, Brazil’s interest would strengthen considerably. Then there would be a combination of the interests that here are divided up between Brazil and Britain: namely, the interests in property protection, the reputation of the financial infrastructure, etc.

46. *See supra* note 40.

D. The United States: Site of the Transaction

As we saw before, the SEC seems to view the site of the transaction as having primary importance so far as the assertion of jurisdiction is concerned, and it has reasonable grounds today for making this claim.⁴⁷ To the extent that the concern about the integrity of the marketplace—the reputation of the trading mechanism—is really what drives insider trading regulation, then the trading in our hypothetical plainly affects a significant U.S. interest. So, too, if we make our concern the more specific one of lowering bid-ask spreads on the domestic markets. Here, U.S. expenditure of enforcement resources on cross-border insider trading represents an investment in local brand quality and trading efficiency. It may be cost effective even if the issuers (and many of their investors) are foreign, so that the regulation benefits many non-U.S. persons as well.⁴⁸

Basing jurisdiction on trading market location has some enforcement efficiencies as well. The bringing of an insider trading case, in the U.S. at least, begins with the internal surveillance that is done on the New York Stock Exchange, the Amex and NASDAQ. It is then aided by the electronic record-keeping that the SEC demands from registered broker-dealers who route trades to these trading systems, which can be delivered quickly to the Commission and analyzed for evidence of trading clusters and other circumstantial evidence of insider trading. This exchange-oriented detection system fits well with the exercise of jurisdiction by the exchange's country.

As sensible from a policy perspective as all this seems, however, I find it conceptually problematic in light of the rapid fragmentation of the world's trading markets. Assume that the world markets gradually move to an integrated system of competing marketmakers, linked by a variety of communication networks that allow for the prompt execution and reporting of trades to some centralized disclosure system.⁴⁹ Add to this the

47. For a broad and powerful claim that securities market regulation is a key to worldwide convergence of securities law, see John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 Nw. U. L. REV. 641 (1999). See also James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999).

48. As Coffee points out, there is a coherence argument here as well: it is awkward for the U.S. to make a strong moral claim against insider trading unless it says that *all* exchange-based insider trading is unlawful, regardless of the issuer's domicile. See Coffee, *supra* note 47, at 694-95 & n. 202.

49. This is not implausible. See Press Release, Securities and Exchange

growth of internet-based sites that investors could access directly, with trades being crossed internally unless better execution could be obtained elsewhere. These competing marketmakers and trading centers would exist in many different countries (or perhaps just the abstraction of cyberspace⁵⁰), with no predictable pattern in terms of where any given trade would occur.

In this setting, one thing is clear: the notion of a "listing" of a stock that is tied to a physical or electronic "place" where the majority (or even the largest percentage) of daily trading in that issuer's stock will occur collapses. Fragmentation means that trading occurs in a highly diffused environment. Besides the obvious difficulties that this poses for surveillance and investigation,⁵¹ it raises the question of whether any given nation would find it economical to seek to enforce its insider trading rules based simply on the happenstance that a particular trade found its way to some system located within its borders. Given a broad diffusion in the benefits from insider trading regulation, there are massive free-rider problems.

There are two counterarguments to consider, however. One is that if, indeed, insider trading regulation lowers bid-ask spreads, then a nation might be able to give "its" domestic trading systems a competitive advantage, causing more trades to be routed there, making this system (and its surrounding institutions) more profitable. This, however, seems difficult to achieve in practice for several reasons. First, the difficulty of surveillance and enforcement in a fragmented environment means that it will be hard to deliver a credible promise to limit insider trading. Further (but closely related to the foregoing), we would still have to ask precisely how much tangible benefit would come from aggressive enforcement by the trading site nation. If the amount of benefit is small, it may not offset other advantages (i.e., execution costs) offered by other sites, in which case trades will continue to move to those other locations notwithstanding suboptimal insider trading enforcement. In that event, general bid-ask spreads will remain sizable, because the marketmakers could not predict any systematic

Commission, NYSE's Recision of Rule 390 and Commission Request for Comment on Market Fragmentation (Feb. 23, 2000), available at <http://www.sec.gov/news/press/pressarchive/2000press.shtml> (last visited March 27, 2001).

50. On insider trading in cyberspace generally, see Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J. L. & TECH. 263 (1999).

51. For a discussion, see Michael Mann et al., *International Agreements and Understandings for the Production of Information and Other Mutual Assistance*, 29 INT'L LAW. 780, 837-38 (1992).

benefit from insider trading regulation when the trades could so easily end up in a place without a well-woven regulatory net.

The second possibility—which is gaining considerable attention in academic circles in the U.S.—is to decouple the idea of a “listing” from an expected trading site and simply make it a regulatory commitment.⁵² That is, issuers from around the world could *elect* to be covered by U.S. (or any other country’s) securities law, including its system of insider trading regulation and enforcement. To finance this, there would be some sort of taxation. Foreign issuers would choose to pay this, and be subject to the resulting enforcement risks, if they perceived that the U.S. (or other country’s) “brand” of securities regulation delivered more value in terms of higher stock prices and lowered cost of capital. Some commentators have suggested that this is indeed occurring today in the form of increased foreign listings on U.S. exchanges,⁵³ as a means by which issuers can avoid the chill that comes from being incorporated in a country with inferior investor protection. Even if listings fall in the face of fragmentation, such a system could be sustained simply by having foreign issuers “rent” some other country’s regulation.

We shall return to this possibility in the next section. But for now, simply recognize that in the latter event, we would no longer be using trading site as the basis for jurisdiction, but rather “issuer consent.” It is a new basis for jurisdiction that would apply even when the issuer, the trader, the source, *and* the trading site are outside the borders of the country in question.

IV. Sorting Out the Claims: Toward an Issuer-based Emphasis

To the extent that exchanges and trading locations remain important places to which a nation could meaningfully devote regulatory resources in such a way as to capture the benefits of regulation for its constituents, basing insider trading jurisdiction on that nexus alone seems appropriate. However, as I have just suggested, I doubt that that system is stable in light of the potential for rapid fragmentation and globalization of trading locations. To the extent that this occurs, we are likely to observe a system of international securities regulation in which multiple trading sites

52. See Stephen Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 SO. CAL. L. REV. 903 (1998). For a similar thesis, see Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

53. See Coffee, *supra* note 47.

will be regulated simply to assure proper execution of orders without undue conflicts of interest, with little or no claim by either the sites or the regulatory authorities as to matters relating to the governance or disclosure policies of issuers whose shares can be traded on them.

If this is the world toward which we are moving, then a shift in regulatory philosophy is needed—for insider trading as well as securities regulation generally. The clear-cut candidate to fill the void would be an emphasis on domestic issuers.⁵⁴ Even if we assume little about who the shareholders of domestic corporations are (i.e., the extent to which they are citizens of the issuer's home country), a country's interest in the reputation of its domestic issuers for controlling agency costs is compelling. If the U.S., for example, can make its domestic issuers attractive in the world's trading markets by stamping its brand of insider trading regulation on them, then the benefits in terms of cost of capital and allocative efficiency will be considerable. And given the relative mobility of the idea of "site of incorporation"—whether one defines that in terms of the site of incorporation or principal place of business—there will be obvious incentives to adopt relatively efficient forms of regulation lest issuers be penalized by the markets and/or move elsewhere. Identifying the issuer's home country as the primary insider trading regulator also has the benefit of enforcement efficiency: usually, though not inevitably, the investigation of insider trading begins with people and data associated with the issuer.⁵⁵ Having said this, I would agree that there is also a good case for encouraging nations to use their enforcement powers to protect the reputations of domestic financial intermediaries and service providers (i.e., Britain in our hypothetical).

Beyond this, the interesting question is whether a country should seek to rent out its form of regulation, permitting foreign issuers simply to commit to obeying its law (and devoting enforcement resources so as to bond the issuer's commitment) as a way of escaping inferior securities regulation in their home countries. As noted earlier, we arguably have this kind of system today, in terms of secondary listings on major exchanges, which has the effect of triggering that country's securities laws in nearly full force. Even if I am correct that listings are no longer a stable base,

54. This is the clear-cut recommendation of Fox, *supra* note 16, albeit for somewhat different reasons than expressed here.

55. *See supra* p. 4.

the commitment could eventually be made to the regulatory authorities directly.

While this idea has substantial theoretical appeal, I am skeptical of its workability. The key issue is one of economics. Given that the benefits of the regulation will largely be external, issuers would have to be willing to pay a tax to make it worthwhile for the regulator to act. In this regard, note the high enforcement costs (not to mention legal and practical difficulties) associated with investigations that have an almost exclusively extraterritorial character. The tax, in other words, would likely be fairly high to cover the costs. To predict that issuers will indeed choose to pay it, each of the following would have to be true:

- (1) markets would have to be sufficiently efficient to price the added value of the regulation with some degree of precision;⁵⁶
- (2) regulating nations would have to make a sufficient investment in extraterritorial regulation that the markets would assume the quality of not only the law on the books but also the willingness to devote resources to extraterritorial cases—withstanding domestic political pressures to shift those resources secretly in other directions;⁵⁷
- (3) issuer home countries would have to be willing to cooperate with the regulating jurisdiction in order to enable its enforcement;⁵⁸ and
- (4) managers of the issuer must be willing irrevocably to submit to this external jurisdiction to gain the benefits of a better stock price notwithstanding the personal costs associated with moving to a stricter regime.⁵⁹

56. For skepticism on this, see Cox, *supra* note 47, at 1233-35.

57. Given the opaque nature of governmental enforcement, there needs to be some bonding mechanism by which investors can take confidence that there will be appropriate enforcement not only now, but in the future. Some scholars point to Delaware as a state that, in corporate law, has succeeded in making a credible commitment to the capital marketplace about the stable quality of its law. Note, however, some unique features about Delaware. First, it assigns enforcement capacity to private parties, not public enforcement. Second, it has a near monopoly on public company incorporations (and is highly dependent on the resulting revenues), giving it a unique incentive to act responsively.

58. Ironically, as regulatory responsibility shifted largely to a handful of nations that could specialize in investor protection, the incentive for other countries to build a solid infrastructure for securities enforcement would diminish.

59. For skepticism on this, see Lucian Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 STAN. L. REV. 127 (1999).

There is nothing theoretically impossible about this, my suspicion is that one or more of them are likely to prove untrue. If so, it is hard to envision such a system being built and sustained for some time. In the intermediate-term, then, the sensible future of cross-border insider trading enforcement is one that assigns to countries the task of protecting of their own issuers and, derivatively, the investors in those issuers.

I use the phrase "intermediate term," however, because in a globalized capital marketplace, I am not even sure that issuer domicile (however defined) is a sustainable standard. With respect to truly multi-national companies, whose shareholders, managers and other functional elements have no strong connection to any given country, I find it difficult to believe that any one country will use its scarce domestic investigatory and prosecutorial resources aggressively to regulate insider trading. The enforcement costs to be borne by that country are great, while the benefits go in substantial part to foreign investors and intermediaries. While some system of taxing issuers might be found, I have some doubts about whether domestic agencies will really spend those resources on international policing (within the hidden bureaucratic world of prosecutorial discretion) when faced with competing claims involving stronger domestic connections.

What, then, is the long-term solution? There are really only two possibilities, both involving the creation of a multi-national organization to which some of the tasks of insider trading surveillance and enforcement (coupled, obviously, with a large chunk of the work of securities regulation) is given. Conceivably, this could be a private self-regulatory organization, playing something of the role that exchanges do today. While some of the work of international securities regulation could fit into such an organization, I doubt that it works for insider trading. SRO's are workable vehicles for coordinating the behavior of business actors with reputational interests in continuing to be a member in good standing of the community. But insider trading does not involve that: it involves a wide variety of persons, insiders and outsiders, who see a chance at quick profits. The necessary alternative, then, is a public international organization—IOSCO recharacterized on a grand scale—with full criminal and civil power.⁶⁰ We are far from having such a body, with self-evident and perhaps insuperable

60. For a comparable claim within the European context, see Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANS. L. 9 (1999).

political difficulties standing in the way of its creation. My end point simply is this: absent such an organization, the problems associated with cross-border insider trading enforcement will grow without much hope of satisfactory deterrence.