Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law

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I. INTRODUCTION

Early in the morning of October 17, 2007, a computer hacker invaded the online systems of Thomson Financial ("Thomson"), which disseminates earnings reports and other press releases for publicly-traded corporations. The hacker began probing Thomson's confidential files for an anticipated earnings release from IMS Health Inc., a NYSE company,

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but to no avail.[1] Repeated attempts failed to yield this material non-public information, as IMS Health had not yet sent it to Thomson, who was to keep it confidential until 5:00 p.m. when the earnings information would be released to the investing public. Shortly after 2:00 p.m., however, when Thomson received and uploaded this information to a confidential server, it became vulnerable to the hacker's final foray, just minutes later. Within twenty-seven seconds of the upload, the hacker broke through Thomson's security system, and downloaded the unfavorable earnings report.[2]

By 2:52 p.m., the alleged hacker, a Ukrainian citizen named Oleksandr Dorozhko, began purchasing $41,670.90 in put options of IMS Health,[3] betting that the share price would drop significantly. Unsurprisingly, when the public learned of the information later that afternoon, the stock price sank almost 30 percent, at which time Dorozhko sold the put options at a net profit of $286,456.59.[4] Given the suspicious and successful nature of Dorozhko's trades contemporaneous with the earnings release, the brokerage house immediately froze his account and contacted the Securities and Exchange Commission (the "Commission"). Soon after, the Commission began a formal inquiry, eventually filing a civil claim for insider trading in the United States District Court for the Southern District of New York (the "Southern District Court").[5] Those undisputed facts would appear to present an open-and-shut case of unfair trading on material[6] non-public information—more colloquially known as "inside" information.

The Southern District Court, however, held otherwise. When the Commission moved to freeze Dorozhko's assets, United States District Judge Naomi Reice Buchwald ruled that the Commission was *not* likely to succeed on the merits of the case brought under the Securities Exchange Act of 1934 (the "Exchange Act") given the status of judicial precedent in this area, and denied the requested preliminary injunctive relief. In sum, Judge Buchwald stated that Supreme Court case law

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[1] SEC v. Dorozhko, No. 07 Civ. 9606, 2008 U.S. Dist. LEXIS 1730, at *10 (S.D.N.Y. Jan. 8, 2008).

[2] *Id.* at *11–12.

[3] "A put option is the right to sell a security at a specified price; thus, the value of a put option increases as the price of the underlying security falls." Magma Power Co. v. Dow Chem. Co., 136 F.3d 316, 321 n.2 (2d Cir. 1998).

[4] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *13–14.

[5] *Id.* at *14.

[6] "'Materiality' depends on the significance the reasonable investor would place on the withheld or misrepresented information," and is necessarily a fact-specific inquiry. Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988). The Commission recently established Rule 10b5-1, making clear that liability under 10(b) does not require the Commission to prove that a person actually used material non-public information, mere possession of the information while making a purchase or sale of a relevant security is sufficient to create the assumption of such use. *See* 17 C.F.R. 240.10b5-1(b) (2009).

required the Commission to establish a relationship of trust or confidence between Dorozhko and either the issuer of the securities in which he traded, or with the source of his information. Without that requisite fiduciary relationship, no violation of the Exchange Act could have occurred. Judge Buchwald stayed her ruling to allow the Commission to appeal before Dorozhko's ill-gotten gains were released from U.S. custody (and lost for good).[7]

On February 27, 2008, the Court of Appeals for the Second Circuit (the "Second Circuit"), without issuing a published opinion, stayed Judge Buchwald's decision, and allowed the asset freeze to remain in place pending a determination of the merits of the preliminary injunction.[8] Until the Second Circuit determines otherwise, the status of the law under Section 10(b) of the Exchange Act remains as aptly stated by the Commission in their reply brief to the Second Circuit:

> [T]he principal drafter famously paraphrased the statute as 'Thou shalt not devise any other cunning devices.' Now, nearly 75 years after the passage of the Exchange Act, defendant offers a startling new reading of the law: what Congress actually meant is 'Thou shalt not breach any fiduciary duty; absent such a duty, thou mayest lie as much as thou wishes.'[9]

Just as easily as Dorozhko slipped through Thomson's online security networks to obtain confidential information, he also seems to have slipped through a loophole in U.S. insider trading law to remain entirely free of such liability. Even as courts use their creativity to stretch the existing precedent to its logical extreme, so long as there continues to be a requirement of a fiduciary duty and a breach of that duty, there will remain a significant loophole as evidenced by *Dorozhko*. Because information thieves and, notably in this era of internet commerce, electronic information thieves, owe no duty to the company about which the information pertains, nor to the source of the stolen information, they are able to exploit this antiquated legal framework to trade on the informational fruits of their crimes with material information unknown to the trading public. The regime as it exists today in the United States creates a paradox wherein those who have obtained information in an illegal manner may trade on it without fear of liability under the Exchange Act whereas those who have obtained the information in a legal fashion are prohibited from doing so.

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[7] *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *16 n.6,*64.

[8] SEC v. Dorozhko, No. 08-0201-CV at 1 (2d Cir. Feb. 27, 2007).

[9] Reply Brief of Plaintiff-Appellant SEC, SEC v. Dorozhko, No. 08-CV-0201, at 2 (2d Cir. Aug. 4, 2008).

This article discusses the history and future implications of the status of this law as it now exists in comparison to the securities laws of the European Union ("E.U."), which have effectively closed this gap in insider trading liability. Section II reviews the history of insider trading law in the United States, including the original intent of those who drafted the Exchange Act in reaction to the stock market crash of 1929, and how judicial interpretation of the Exchange Act has followed and expanded upon such intent. Section III discusses the securities laws of the E.U., and how E.U. legislators have updated insider trading prohibitions to defend against modern abuses in this area, in contrast to U.S. law. Finally, Section IV discusses the distinction between E.U. and U.S. law, and the implications of U.S. law as it currently exists.

II. HISTORY OF UNITED STATES INSIDER TRADING LAW

In the wake of the stock market crash of 1929, the United States Congress enacted the Exchange Act, which notably contained Section 10(b), prohibiting the use of any manipulative or deceptive device or contrivance in connection with a purchase or sale of any security.[10] Many of the Congressional hearings prior to the passage of the Exchange Act centered around combating corrupt and deceptive practices in the securities industry, which Congress largely blamed for the market crash.[11] Although more recent studies indicate that political motives may have been at play in exaggerating the presence of these abuses, there was ample evidence that corporate insiders were abusing their access to inside information to garner personal profits.[12]

The Exchange Act generally defines one of its principal purposes as "insur[ing] the maintenance of fair and honest markets."[13] Similarly, in

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[10] 15 U.S.C. § 78a (2006).

[11] JAMES D. COX, DONALD C. LANGEVOORT & ROBERT W. HILLMAN, SECURITIES REGULATIONS: CASES AND MATERIALS 5 (5th Ed. 2006). For example, Senator Duncan Fletcher (D-Fl), the Chairman of the Senate Committee on Banking and Currency at the time the Exchange Act was drafted, declared that investigation into the securities industry exposed various corrupt practices including unfair methods employed by those in possession of inside information regarding "corporate affairs" which had operated "to the great detriment of the investing public" and contributed to investor losses. Securities Exchange Act of 1934, 73d Cong. Sess. 2 (1934) (statement of Sen. Duncan U. Fletcher, Senate Committee on Banking and Currency).

[12] *Id.* at 6*; see also* Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343 (1999).

[13] 15 U.S.C. § 78b (2006); *see also* SEC v. Zandford, 535 U.S. 813, 819 (2002) (internal citations omitted) ("Among Congress' objectives in passing the Act was to insure honest securities markets and thereby promote investor confidence after the market crash of 1929. More generally, Congress sought to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."); United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("[The] purpose of the Exchange Act [is] to insure honest securities markets and thereby promote investor confidence.").

establishing the subsequent and explanatory Rule 10b-5—commonly understood as the prohibition against insider trading—the Commission, acting under its rule-making powers as delegated by Congress,[14] explicitly stated that its purpose was "to assure that dealing in securities is fair and without undue preferences or advantages among investors."[15] Despite these statements indicating a more general intent of market equality, much of the Congressional focus in drafting the Exchange Act's prohibition of insider trading was on a more narrow concern about abuses by those in fiduciary relationships to the company with access to non-public information.

For example, the Chairman of the Senate Committee on Banking and Currency stated in his Committee Report that "[a]mong the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities."[16] Additionally, he commented that "[t]he bill . . . aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others."[17] The Chairman of the House Committee on Interstate and Foreign Commerce similarly pointed to the abuses by fiduciaries in saying that "[s]peculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web. No one of these evils can be isolated for cure of itself alone."[18] He continued to stress this point in remarking that:

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[14] 15 U.S.C. § 78j(b) (2006).

[15] H.R. CONF. REP. NO. 94-229, at 91 (1975) *as reprinted in* 1975 U.S.C.C.A.N. 321, 322.

[16] S. *Rep. No. 73*-1455, at 55 (1934). Fletcher also noted that the Committee was aware that directors and officers were not the only persons in possession of confidential information, and that large stockholders, who had sufficient control over their companies, were also to blame for "the unscrupulous employment of inside information" which was uniquely available to them. *See id*. Thus, continued Fletcher, "[t]he Securities Exchange Act of 1934 aims to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty." *Id.* Those owing a fiduciary duty were entrusted with money from the investing public, making their exploitation of confidential information particularly unfair. Recognizing that such "unscrupulous" individuals may continue to exploit their inside information "by devious and underhanded methods," the Exchange Act would function at the very least to "tend ultimately to drag these devices into the open where they may be dealt with according to their desserts." *Id.*

[17] *See* S. *Rep. No.* 73-792, at 8–9 (1934).

[18] H.R. Rep. No. 73-1383, at 5-6 (1934*)* (Rayburn) (arguing that the "exploitation of . . . ignorance by self-perpetuating managements in possession of inside information"

> A renewal of investors' confidence in the exchange markets can be effected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage.[19]

Despite the stated intent of ensuring market fairness as generally described in the text of the Exchange Act, in the decades since Congress promulgated the law, courts interpreting insider trading prohibitions have mirrored the concerns of the Committee Reports, stressing the unwavering requirement that a fiduciary duty be breached in order to establish insider trading liability.[20] There simply is no "general duty between all participants in market transactions to forgo actions based on material non-public information."[21]

Specifically, the Exchange Act prohibits one from using or employing "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5 explained further that it is unlawful for any person to "[t]o employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security."[22] Because there is no explicit prohibition of "insider trading" per se, the rule against such conduct has been inferred by courts interpreting Section 10(b) and Rule 10b-5[23] based on their language and intent. Simply put, a violation requires the Commission to establish three elements: (1) a "device or contrivance";

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was to blame at least in part for the disastrous consequences of recent speculation in securities markets).

[19] *Id.* Similar to Fletcher's concession (*see* n. 16 *supra*), Rayburn admitted that the insider trading prohibitions were not "air-tight," leaving the possibility that the "unscrupulous insider" may continue to exploit confidential information. However, the Exchange Act aimed to shed light on the abusive practice of insider trading, bringing these methods into "disrepute and encourage[ing] the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises."

[20] *See, e.g.,* Chiarella v. United States, 445 U.S. 222, 233 (1980) (declining to impose a general duty on all market participants to forgo trading on material non-public information because "such a broad duty . . . should not be undertaken absent some explicit evidence of congressional intent. As we have seen, no such evidence emerges from the language or legislative history of § 10 (b)"). *See also* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 184 (arguing for a move away from the "fiduciary-based rationale" to a "fairness-based system" of liability).

[21] *Chiarella*, 445 U.S. at 233.

[22] 17 C.F.R. § 240.10b-5 (2008).

[23] *See, e.g.*, United States v. O'Hagan, 521 U.S. 642 (1997); Dirks v. SEC, 463 U.S. 646 (1983); *Chiarella*, 445 U.S. at 222; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

(2) which is "manipulative or deceptive"; and (3) used "in connection with" the purchase or sale of securities.[24]

The focus of this article is on the legal terminology contained in the second prong of the prohibition, "manipulative or deceptive." It therefore assumes that there has been a subsequent "purchase or sale"[25] while the individual was in possession of the so-called "inside" information,[26] and that electronic hacking qualifies as a "device or contrivance."[27] The Supreme Court has defined the term "manipulative" very narrowly in the area of securities law, generally requiring "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[28] Thus, to fit an act of insider trading under the rubric of Section 10(b) and Rule 10b-5 it must be "deceptive."[29]

Although the common understanding of the term "deceptive" would appear to include the scenario described above as perpetrated by Dorozhko, Supreme Court precedent makes it abundantly clear that a breach of a fiduciary duty, or some derivation thereof,[30] must occur for conduct to be deemed "deceptive."[31] This interpretation stems from the historical understanding of fraud, which encompasses "deceptive" conduct, as implying a duty to "disclose or abstain."[32] In other words, any actor in a relationship of trust with another party shall either disclose

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[24] *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *18–19.

[25] *See infra* at Section IIB. As is evident in the chart of implementing legislation *infra* at Section IIB, the E.U. Directive and Member States have prohibited the passing of inside information even where there is no subsequent trading on such information; merely the act of disclosing the information is a civil or criminal violation. Given the potential conflicts in United States law, most notably with the First Amendment of the United States Constitution, this stands as another stark contrast to the U.S. liability scheme but is beyond the scope of this paper to analyze in depth.

[26] United States law defines what is colloquially known as "inside" information to be "material non-public information." *See, e.g., Chiarella*, 445 U.S. at 230.

[27] A "device" under the first prong is a requirement easily established in the circumstance of electronic data hacking pursuant to the Supreme Court's definition as "that which is devised or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; and artifice." *Ernst & Ernst*, 425 U.S. at 199 n. 20 (internal citations omitted). Courts have held that electronic hacking to obtain information qualifies as an artifice or scheme, with the requisite intent. *See, e.g., Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *18.

[28] *Ernst & Ernst*, 425 U.S. at 199; *see also* Santa Fe Indus. v. Green, 430 U.S. 465, 476 (1971) (explaining that the terms "manipulative" "refers generally to practices such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity"); Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 6 (1985).

[29] *See*, *e.g.*, *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *20–22.

[30] *See* Section IIA–B for a discussion of the various derivations of confidential relationships for purposes of insider trading law.

[31] *See, e.g., Zandford*, 535 U.S. at 825; *O'Hagan*, 521 U.S. at 655; *Chiarella*, 445 U.S. at 222; *Santa Fe Indus*., 430 U.S. at 470.

[32] *See, e.g., Chiarella*, 445 U.S. at 227.

the material information at stake or abstain from continuing the transaction. Growing from these common law roots, judicial interpretation of insider trading law now requires that a relationship of trust exist before an individual is required to disclose his confidential information, and thus before a violation of law can occur.[33] Subsequent courts have become more creative in finding the requisite fiduciary relationships, expanding upon the "traditional theory" under which company insiders could be held liable given the fiduciary relationship they owe to their shareholders.[34] These interpretations include assigning liability to "tippees" to whom information was given by a corporate insider,[35] and even go so far as to include those who have "misappropriated" inside information, but who do not have any relationship to the company whose securities are at issue, instead breaching a duty of trust only to the source of the information.[36]

A brief history of the development of U.S. insider trading law illustrates the difference between U.S. law and that promulgated by the E.U. Unlike the E.U. which had the unique ability to adapt its regulations to comport with modern technological and other advances, U.S. insider trading laws, and the precedent thereunder, are constrained by legislation adopted nearly eight decades ago.

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[33] *See, e.g., id.* at 228–29; Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc., 186 F.3d 157, 169 (2d Cir. 1999).

[34] *Simon DeBartolo Group,* 186 F.3d at 169 (citations omitted) (internal quotations omitted) ("Under the 'traditional theory' of insider trading, this prohibition is limited by the requirement that the defendant be under a specific duty either to disclose or to abstain from trading. This duty does not, however, arise from the mere possession of material non-public information. Rather, a duty to disclose or abstain arises only from a fiduciary or other similar relation of trust and confidence between the parties to the transaction.").

[35] *See Dirks*, 463 U.S. at 646; *see also* United States v. Evans, 486 F.3d 315, 320 (7th Cir. 2007); United States v. Hughes, 505 F.3d 578, 593 (6th Cir. 2007) ("the Government was also required to prove that . . . tippees: (1) received material, confidential, and non-public information from [the tipper] knowing that he was the source; (2) knew or should have known that [the tipper] breached his fiduciary duty; and (3) knowingly and willfully purchased or caused to be purchased shares of . . . stock based on that information."); SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003); Randall v. Rational Software Corp., 34 Fed. Appx. 301 (9th Cir. 2002); SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998) (stating that, to affirm a tippee's liability under § 10(b), the SEC must establish that (1) the tipper possessed material non-public information; (2) the tipper disclosed this information to the tippee; (3) the tippee traded in the shares of the company about which the material non-public information pertained while in possession of that information provided by the tipper; (4) the tippee knew or should have known that the tipper violated a relationship of trust by relaying the information; and (5) the tipper benefited by the disclosure to the tippee); United States v. Ruggiero, 56 F.3d 647, 655 (5th Cir. 1995) ("an individual need not have a direct relationship with the company to violate the securities law by trading on inside information; a 'tippee', one who acquires information from an insider, may also violate the rules against inside information.").

[36] *See, e.g., O'Hagan,* 521 U.S. at 642; SEC v. Talbot, 530 F.3d 1085, 1091 (9th Cir. 2008); *Simon DeBartolo Group*, 186 F.3d at 171.

A. The Traditional Theory of Insider Trading: "Disclose or Abstain" by Corporate Insiders

The traditional theory of insider trading liability has its roots in the "disclose or abstain" rule at common law. In the landmark case of *In the Matter of Cady, Roberts & Co v. SEC*, the Commission relied upon the special relationship of trust owed by a corporate insider to the shareholders of his company to support its finding that a director of a securities issuer is prohibited from executing trades in such securities while in possession of information not yet known by the investing public.[37] That duty arises from the existence of a relationship that provides access to the inside information, which is intended to be available only for a corporate purpose, and the unfairness of a corporate insider taking advantage of that information by trading without disclosing it.[38] Thus, it follows that those insiders must either disclose the material non-public information known to them because of their unique position in the company, or abstain from trading entirely.

The "traditional theory" of insider trading law states simply and logically that a corporate insider violates Section 10(b) and Rule 10b-5 when he or she trades in the securities of his or her corporation on the basis of material non-public information.[39] Trading on such information that is not generally known to the investing public, and which would substantially affect the judgment of a reasonable investor, qualifies as a "deceptive device" due to the relationship of trust and confidence between the shareholders of a company and the insiders of that company who possess confidential information due to their position within the company.[40] Included under the umbrella of corporate insiders are not only the officers, directors, or other similarly situated employees of a particular company,[41] but also the attorneys, consultants, accountants, or other persons who can become temporary fiduciaries of the company.[42] These "temporary insiders" adopt a fiduciary duty to the shareholders of the company for which they are providing services by virtue of their business relationship and access to confidential information.[43]

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[37] In re Cady, Roberts & Co., 40 S.E.C. 907, at 10 (S.E.C. 1961) ("We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position by which are not known to persons with whom they deal and which, if know, would affect their investment judgment.").

[38] *Id*. at 912 n.15.

[39] *Chiarella*, 445 U.S. at 228.

[40] *Id.*

[41] *See id.*; *O'Hagan*, 521 U.S. at 651–52.

[42] *Dirks*, 463 U.S. at 655 n.16; *O'Hagan* 521 U.S. at 652; *see also* United States v. Chestman, 947 F.2d 551, 565 (2d Cir. 1991).

[43] *Dirks*, 463 U.S. at 655 n.14 ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons

In confirming this theory of insider trading liability, the Supreme Court in *United States v. Chiarella* noted its historical roots, explaining that at common law, fraud exists where affirmative misrepresentations are made to induce the reliance of another party *or* where the offending party fails to disclose material information prior to a transaction when that party has a duty to do so.[44] The duty to disclose is found where the offending party is in possession of information "that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[45] Given the Commission's recognition of a relationship of trust and confidence between a corporate insider and the shareholders of the insider's company, the insider has an obligation to disclose given "the necessity of preventing an insider from taking unfair advantage of the uninformed minority stockholders"[46] or simply when the insider takes advantage for his or her own benefit.[47] Thus, the *Chiarella* Court stated that the "application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material non-public information."[48]

In so deciding, the Supreme Court overruled the determination of the Second Circuit which had affirmed Chiarella's conviction, disregarding the need for a fiduciary duty. Instead, the Second Circuit relied on the core principle that U.S. securities laws were supposed to have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions."[49] In effect, such a

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acquired non-public corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.").

[44] *Chiarella*, 445 U.S. at 227–28. This case concerned an employee of a printing company who, by reading takeover bids being printed by his employer, deduced the names of target companies. Without disclosing his knowledge, Chiarella bought stock in the target companies, and subsequently sold such stock shortly after the takeover attempts were made public. For his realization of over $30,000 in profit over the course of fourteen months, Chiarella was indicted for seventeen counts of violating Section 10(b) of the Exchange Act, and was found guilty of all counts. In overturning his conviction, the Supreme Court held that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." *Id.* at 228. Stating this in the reverse, one must affirmatively breach some brand of duty because he or she can be held responsible for fraud in connection with Section 10(b).

[45] *Id.* at 228 (*citing* RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

[46] *Id.* at 228–29 (*citing* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951)).

[47] *Id.* at 229.

[48] *Id.* at 230. The jury instructions charged the jury with deciding whether Chiarella used material non-public information when "he knew other people trading in the securities market did not have access to the same information." *Id.* at 231 (*citing* R. at 677). These were found to be erroneous, given the absolute requirement of a breach of fiduciary relationship.

[49] United States v. Chiarella, 588 F.2d at 1358, 1362 (2d. Cir. 1978). This theory of providing equal access was outlined previously by the Second Circuit in SEC v. Texas

premise would have imparted "a general duty between all participants in market transactions to forgo actions based on material non-public information."[50] This theory, though embraced by legislators around the world in creating schemes for insider trading liability based upon general equality among market participants,[51] was expressly rejected by the Supreme Court in *Chiarella* because the "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of Congressional intent."[52] As discussed above, such intent was heavily premised on fiduciary relationships. With the majority decision requiring such a relationship,[53] U.S. insider trading law irrevocably turned away from the notion of general fairness in the market place, a concept embraced by nearly every other developed nation,[54] toward the more limited framework mandating a fiduciary relationship.

B. Liability of Tippees: Expanding the Fiduciary Relationship

The Supreme Court used this traditional theory as a jumping off point to extend liability to "tippees", or those persons to whom a corporate insider has passed information, but who do not otherwise have any duty to the company about which the information pertains.[55] In order to satisfy the fiduciary requirement, courts have adopted the theory that the tippee assumes the liability of the fiduciary relationship between the

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Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (finding Section 10(b) "applicable to one possessing the information who may not be strictly termed an 'insider' . . . 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."). Additionally, this is precisely the reasoning accepted by Justice Blackmun dissenting in *Chiarella,* arguing that Section 10(b) does not require a fiduciary relationship. *See* note 53, *infra*.

[50] *Chiarella*, 445 U.S. at 233.

[51] *See* Section IIIA, *infra.*

[52] *Chiarella,* 445 U.S. at 233. That the Court found "no such evidence" of a "parity-of-information rule" in either the language or legislative history is unsurprising, given the heavy emphasis on traditional insiders of the Congressional Committees as discussed at Section II *supra*.

[53] Justices Blackmun and Marshall, dissenting from the majority opinion, argued that the longstanding principle that federal securities laws are to be construed flexibly dictates, and that their purpose is "to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate." *Id.* at 247–48 (Blackmun, J., Marshall, J, dissenting). The simple fact that the defendant "stole" information was "the most dramatic evidence" of fraud, thus formulating a far broader rule that those persons having access to information not legally available to others should be prohibited from exploiting such position by trading in the relevant securities. *Id.* at 246–51. "To hold otherwise . . . is to tolerate a wide range of manipulative and deceitful behavior." *Id*.

[54] *See* Section III, *infra*.

[55] *Dirks*, 463 U.S. at 659–64.

corporate insider and the company when such insider passes the information along.[56] In *Dirks v. SEC*, the Supreme Court found that the tippee "assumes a fiduciary relationship with the shareholders of the corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[57]

For example, in *United States v. Evans*,[58] a financial analyst at Credit Suisse, Paul Gianamore, passed along material non-public information to a long-time friend, Ryan Evans, who subsequently traded on that information for a handsome profit.[59] Although Evans, the "tippee," did not owe a fiduciary relationship to Credit Suisse, as a corporate insider Gianamore did, and breached that duty when he passed along material non-public information.[60] Upon receiving the information, knowing that Gianamore had breached his own fiduciary duty to Credit Suisse, Evans assumed Gianamore's fiduciary duty to the company's shareholders and was ultimately found guilty for his trading activities.[61]

C. The Misappropriation Theory of Insider Trading Liability: A Further Extension

Continuing to expand the relationships that may qualify under Section 10(b), the Supreme Court in *United States v. O'Hagan* set forth a "complementary" theory to the traditional understanding of insider trading law in the "misappropriation theory."[62] The Court held that a violation occurs when an actor misappropriates confidential information for the purpose of securities trading, in breach of a duty owed to the *source of the information*, rather than requiring a relationship to the shareholders themselves.[63] As the Supreme Court stated, an

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[56] *Id.*; *see also* United States v. Falcone, 257. F.3d 226, 229–30 (2d Cir. 2001).

[57] *Dirks,* 463 U.S. at 660.

[58] United States v. Evans, 486 F.3d 315, 320–26 (7th Cir. 2007).

[59] *Id.* This case presents the ironic scenario where the tippee may be held liable for insider trading while the tipper is not held accountable. Because the legal standard focuses on the tippee's knowledge that the tipper is breaching a fiduciary duty—not the tipper's knowledge that his actions constitute such a breach—a scenario such as this may arise where the tipper acted innocently and the tippee is the only party ultimately culpable.

[60] *Id.* at 323.

[61] *Id.*

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

[63] *Id*. Although *O'Hagan* is widely recognized as the seminal case defining the misappropriation theory, the first time the theory was briefed was in *Chiarella*, where the Commission argued the requisite breach of trust exists where an outsider breaches a duty to the corporate insider who gave him the information, which would replace the breach owed to the market participant under the traditional theory. *See Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *31–32. Although adopted by Justices Blackmun and Marshall in

"undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty or confidentiality, defrauds the principal of the exclusive use of that information."[64] By moving away from requiring a relationship between an insider and the shareholders, the Court affixed liability to the "fiduciary-turned-trader" when such a person is entrusted with access to confidential information, regardless of any relationship to the shareholders, and breaches the trust with source of the information by trading on it.[65]

In *O'Hagan*, the defendant acquired material non-public information in the course of representing the potential acquiring company in a possible tender offer.[66] Prior to the public release of information about the deal, O'Hagan purchased call options[67] in the target company's stock, thus earning a profit of $4.3 million when the deal was made public.[68] Despite the fact that O'Hagan was found guilty under Section 10(b) at the District Court level, the Eighth Circuit

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dissent, the majority refused to consider the theory because it had not been submitted to the jury. *Chiarella*, 445 U.S. at 235–36.

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

[65] *Id.* The duty of trust need not be owed to the original source of the information. *See*, *e.g.*, *Talbot*, 530 F.3d at 1093. The courts have found that a "continuous chain" of duties may suffice to extend liability to information recipients who are connected to the issuer only through a chain of information passing. In that way, a defendant may be held liable when he owes a duty to the source of information, who in turn owes a duty to the issuer. *See*, *e.g.*, SEC v. Cherif, 933 F.2d 403, 406 (former employee of a bank liable when he breached a duty to his employer by misappropriating information concerning the bank's clients and traded on such); SEC v. Materia, 745 F.2d 197, 202 (2d Cir. 1984) (employee of a financial printing company liable under misappropriation theory when he traded on information regarding clients of his employer); SEC v. Musella, 578 F. Supp. 425, 438–39 (S.D.N.Y. 1984) (misappropriation theory applied to law firm employee who traded on information about firm's clients). The Ninth Circuit has extended this rule in holding that there need not even be a "continuous chain" so long as there is a duty owed to the defendant's source, regardless of whether the source is the "originating source" or not. *Talbot*, 530 F.3d at 1093 (finding misappropriation theory applicable where a board member of an insurance company traded on information about a lending service in which the insurance company owed a 10% stake when he learned of the information from officers of his company who originally learned of the information from officers of the issuer).

[66] "A tender offer is a broad solicitation by a company or a third party to purchase a substantial percentage of a company's Section 12 registered equity shares or units for a limited period of time. The offer is at a fixed price, usually at a premium over the current market price, and is customarily contingent on shareholders tendering a fixed number of their shares or units." SEC, Tender Offers, http://www.sed.gov/answers/tender.html (last visited June 5, 2009); *see generally* 15 U.S.C. § 78n(d); 17 C.F.R. 240.14d-e.

[67] "A call option gives the holder the right to purchase a specified number of shares of stock by a certain date at a specific price. If the shares are not purchased by that date, the option expires and along with it the right to purchase the specified number of shares. For instance, on August 18, 1988, O'Hagan purchased 100 Pillsbury call options. Each call option gave him the right to purchase 100 shares of Pillsbury stock. Each call option also expired on September 17, 1988, if the option was not exercised." *O'Hagan*, 92 F.3d at 612, 614 n.1 (8th Cir. 1996).

[68] *Id.*

reversed his conviction.[69] Following the Fourth Circuit's lead in *United States v. Bryan*, which rejected the misappropriation theory,[70] the Eighth Circuit accepted the defense's argument that O'Hagan was not an insider of the target company, whose stock he had traded, and therefore the requisite fiduciary duty was missing.[71] Noting the split amongst the Courts of Appeal on the feasibility of the misappropriation theory, [72] however, the Supreme Court responded with another reversal. Expanding the fiduciary requirement to further protect investors against trades made unfairly with confidential information, the purpose of the misappropriation theory is to "protect the integrity of the securities market against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."[73] Soon after the *O'Hagan* decision, the Commission enacted Rule 10b5-2, further clarifying where a "duty of trust or confidence" exists.[74] The regulation delineated which relationships would be encompassed within the misappropriation theory, and included instances where: (1) there is an agreement to maintain a confidence, (2) a relationship between the parties exists such that confidence is expected, or (3) there is a familial relationship.[75]

With this decision, the Court continued moving toward imposing broader liability on unfairly advantaged market participants. Given the enduring requirement of a breach of some form of loyalty or trust,

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[69] *Id.* at 612.

[70] *Bryan*, 58 F.3d 933 (4th Cir. 1995)(narrowing the scope of liability, despite "the principal concern of Section 10(b) [being] the protection of purchasers and sellers of securities," because the statute requires "deception" upon a person in some way connected to a securities transaction, beyond merely a fiduciary breach to a source of information).

[71] *O'Hagan*, 92 F.3d at 612.

[72] *See O'Hagan*, 521 U.S. at 650 n.3 (noting the split between the Fourth Circuit in *Bryan*, 58 F.3d at 943–59 (1995), and the Second, Seventh, and Ninth Circuits respectively in *Chestman*, 947 F.2d at 566, SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991), and SEC v. Clark, 915 F.2d 439, 453 (1990)).

[73] *O'Hagan,* 521 U.S. at 653. Given this stated purpose, however, the Court had to squeeze the misappropriation theory into the required framework of deceit in connection with a securities transaction through a breach of fiduciary duty. *See* Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: a Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1273 (1998). Nagy argues that the Court's emphasis on the harm to investors is misleading because the fraud upon which the Court relied was actually perpetrated on the source of the information with whom the duty of trust existed. *Id.* As this article argues, the Court is stretching the fiduciary relationship to its logical extreme to encompass as much unfair conduct as possible. In effect, however, the misappropriation theory, though disguised as a breached duty is simply a "backhanded way to penalize individuals for reducing investor confidence in the securities markets and for treating investors unfairly." *Id.* at 1274.

[74] 17 C.F.R. § 24010b5-2(b).

[75] *Id.*

however, the misappropriation theory does not go so far as to impose a general scheme of market fairness. For a "misappropriation" of information to occur, there must be a breach, and for the breach to occur, the misappropriator must not disclose to the source of the information his intention to trade in the company's securities.[76] The Court, bound by precedent to uphold the fiduciary requirement, was well aware that scenarios would exist in which those with an unfair trading advantage would not be liable under Section 10(b). For example, Justice Ginsburg specifically mentioned a potential situation in which the source of the information was informed that the recipient planned to trade on the confidential information.[77] Because there would no longer be a breach of the source's confidence, this situation would yield no liability under the misappropriation theory. The Court merely deferred to the possibility of claims under state law to close this gap.[78] Furthermore, some form of a relationship must exist between the source and the misappropriator, thus foreclosing liability for those without any association whatsoever, as would be the case for an electronic data hacker like Dorozhko.

D. Implications of the Fiduciary Requirement

The story of Oleksandr Dorozhko "highlights a potential gap arising from a reliance on fiduciary principles in the legal analysis that courts have employed to define insider trading, and courts' stated goal of preserving equitable markets."[79] When the Commission launched an

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[76] *See generally, O'Hagan*, 521 U.S. at 642.

[77] "[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of the information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no 'deceptive device' and thus no 10(b) violation." *Id.* at 656; *see also id*. at 659 n.9 ("[T]he textual requirement of deception precludes 10(b) liability when a person trading on the basis of non-public information has disclosed his trading plans to, or obtained authorization from, the principal—even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory.").

[78] For example, New York State prosecutes insider trading violations under the Martin Act, its Blue Sky Law. *See, e.g.*, People v. Napolitano, 724 N.Y.S.2d 702, 708 (1st Dep't 2001); People v. Florentino, 456 N.Y.S.2d 638 (N.Y. Crim. Ct. 1982). Rather than expanding upon the scheme of liability under federal law, however, New York Law essentially mirrors existing federal law, leaving the same loopholes available to true outsiders. *See id.*; *see generally,* In re Novich, 728 N.Y.S.2d 22, 23 (1st Dep't 2001) (finding a "federal conviction for securities fraud . . . is 'essentially similar' to the New York felony under the New York State insider trading statute.").

[79] *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *4–5; *see generally* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("The Court has said that the 1934 Act and its companion legislative enactments embrace a fundamental purpose to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry . . . the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly to effectuate its remedial

investigation, and eventually pursued civil claims against Dorozhko, Judge Buchwald of the Southern District Court effectively had her hands tied by Supreme Court precedent. While noting the availability of possible criminal charges for mail or wire fraud,[80] or for hacking under the Computer Fraud and Abuse Act,[81] Judge Buchwald denied the Commission's request for a preliminary injunction to freeze the profits made by Dorozhko on the IMS Health trades, finding that the Commission was not likely to succeed on the merits of proving a 10(b) violation. In doing so, Judge Buchwald stated that,

> in the 74 years since Congress passed the Exchange Act, no federal court has *ever* held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates § 10(b). Uniformly, violations of § 10(b) have been predicated on a breach of fiduciary (or similar) duty of candid disclosure that is 'in connection with' the purchase of sale of securities. To eliminate the fiduciary requirement now would be to undo decades of Supreme Court precedent, and rewrite the law as it has developed.[82]

Notwithstanding Judge Buchwald's assertion that no federal court had ever ruled in contradiction to her position, Judge Haight, also of the Southern District Court, had issued an opinion under extraordinarily similar facts just one year prior. In that case, *SEC v. Blue Bottle Ltd.*,[83] the Commission alleged that the defendants, a Guernsey citizen and the Hong Kong company for which he worked, "fraudulently gained access" by "hacking" or "otherwise improperly obtaining electronic access" to material non-public information from imminent news releases stored on computer systems.[84] Judge Buchwald did not ignore Judge Haight's opinion, but noted that the *Dorozhko* case was distinct in procedural posture since *Blue Bottle* was a default judgment. Judge Buchwald also asserted that Judge Haight did not "produce[] an opinion analyzing the

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purposes."); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

[80] *See* 18 U.S.C. § 1341 (2006); 18 U.S.C. § 1343 (2006). Penalties for mail and wire fraud include a fine and a prison sentence up to 20 years. *Id.*

[81] 18 U.S.C. § 1030(a)(4) (2006). A first-time offender may be fined and imprisoned for up to 5 years; however, a second conviction under this title may result in a fine and prison sentence up to ten years. 18 U.S.C. § 1030(c)(3)(A)-(B).

[82] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *4.

[83] SEC v. Blue Bottle Ltd., No. 07-CV-1380, 2007 U.S. Dist. LEXIS 95992 (S.D.N.Y. Apr. 24, 2007).

[84] *Id.*; Court Orders Temporary Restraining Order and Asset Freeze in SEC Emergency Fraud Action Involving Trading in Advance of Press Releases of 12 U.S. Companies; Foreign defendant garnered profits of over $2.7 million through illegal scheme, SEC Litigation Release No. 20018 (Feb. 26, 2007).

relevant case law, or why the theft of material non-public information amounted to a deceptive device in contravention of the statute," thus rendering his judgment "hardly convincing."[85] Judge Haight did in fact publish an opinion in connection with the ruling, relying heavily on the *Zandford* and *Dirks* cases which Judge Buchwald also cited extensively—but the two judges arrived at precisely opposite conclusions.[86] Without specifying whether the hacker was an "insider," "temporary insider," "tippee," or "misappropriator," Judge Haight outlined the relevant precedent and asserted that the Commission successfully established liability.[87] In contrast, Judge Buchwald analyzed and rejected both the traditional and misappropriation theories of liability, ultimately concluding that Dorozhko was a complete outsider, without any requisite duty to either the stockholders of IMS Health nor to the source of the information. Thus, according to Judge Buchwald, the Commission was not likely to succeed in holding him liable under Section 10(b) for his acts of information theft and subsequent trades thereon.[88]

On appeal to the Second Circuit, the Commission argued that "Dorozhko's hacking was deceptive within the meaning of Section 10(b) regardless of whether he breached a fiduciary duty."[89] The Commission argued that such conduct was "deceptive" because it was a "deceptive trick to gain access to non-public information as if he were one of those few persons authorized to have that access,"[90] and because he had to "retrieve the information, and secretly depart from the compromised computer system."[91] Attempting to frame its understanding of hacking as "deceptive" within the meaning of Section 10(b), the Commission argued that this is not a radical departure from established law as Judge Buchwald had so firmly asserted in her opinion.[92] Noting that each of the cases upon which Judge Buchwald relied involved a defendant with lawful access to non-public information, the Commission drew a distinction in Dorozhko's case where the deception involved could be found in the means by which he accessed the information.[93] The Commission argued that Dorozhko's actions amounted to more than a "straightforward theft" of information, alleging instead there was an

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[85] *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *52.
[86] *Blue Bottle*, 2007 U.S. Dist. LEXIS at *12–14.
[87] *Id.* at *13–14.
[88] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *63–64.
[89] Brief on Behalf of Petitioner-Appellant SEC Motion for Maintenance Pending Appeal, SEC v. Dorozhko, at 11 (Jan. 11, 2008)(appellate number unpublished).
[90] *Id.* at 13.
[91] *Id.* at 12.
[92] *Id.* at 14–15.
[93] *Id.* at 16–18.

added element of deceit.[94] The Commission asserted that this situation was akin to using an expired magnetic identification badge to gain access to non-public information,[95] similar to the facts in *SEC v. Cherif*, where the Seventh Circuit found the defendant's actions to have deprived another person of something of value "by trick, deceit, chicane or overreaching."[96] What the Commission failed to note, however, was that Cherif exploited confidential information he learned as an employee of his former company to break in and steal information about forthcoming transactions.[97] The Seventh Circuit stressed that he was not a "true outsider" as Judge Buchwald characterized Dorozhko.[98]

The Second Circuit, without a written opinion, stayed Judge Buchwald's decision, thereby temporarily allowing the asset freeze to stay in place pending a final decision on the merits of the preliminary injunction.[99] The standard for granting a stay of the freeze pending appeal requires a lower standard of probability of success on the merits than does a preliminary injunction.[100] Whereas the Commission's request for a preliminary injunction in the Southern District Court required "a likelihood of success on the merits,"[101] a standard not met according to Judge Buchwald, the standard for granting a stay pending appeal requires only "a substantial possibility, although less than a likelihood, of success" on the merits of the appeal.[102] Citing this standard without further analysis, the Second Circuit thus recognized that there is at least a "substantial possibility" that 10(b) liability may exist. In addition to the likelihood of success on the merits, however, three other factors weigh in a court's determination of a stay pending appeal, including whether the movant (here the Commission) would suffer irreparable injury absent a stay, whether the respondent would suffer substantial injury if a stay is issued, and whether public interests may be affected.[103] Keeping the freeze in place would not inflict any further harm on Dorozhko, and there is a strong argument to be made that the public interest is served by prohibiting an alleged hacker from disappearing with his ill-gotten gains. Practically speaking, the Second Circuit may simply have been acting to preserve the Commission's access to the funds in question, which

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[94] Brief on Behalf of Petitioner-Appellant SEC Motion for Maintenance Pending Appeal, SEC v. Dorozhko, at 15 n.6 (Jan. 11, 2008)(appellate number unpublished).

[95] *Id.* at 16–17.

[96] SEC v. Cherif, 933 F.2d 403, 411–12 (7th Cir. 1991).

[97] *Id.*

[98] *Dorozhko,* 2008 U.S. Dist. LEXIS 1730, at *41.

[99] SEC v. Dorozhko, No. 08-0201-CV (2d Cir. Feb. 27, 2008)(order granting stay of asset freeze).

[100] LaRouche v. Kezer, 20 F.3d 68, 72 (2d Cir. 1994).

[101] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *16.

[102] *LaRouche*, 20 F.3d at 72.

[103] *Id*.

otherwise would likely be impossible to recover should the freeze be lifted.[104] Whether the stay is an indication of how the Second Circuit ultimately will rule remains an open question to be answered shortly.[105] This case presents a unique and novel opportunity for the Second Circuit to either solidify the existing law as explained by Judge Buchwald, or, as it did previously in its opinion in *Chiarella*, move judicial interpretation towards a fairness-based approach.

III. EUROPEAN UNION DIRECTIVE AND NATIONAL LEGISLATION: FIDUCIARY RELATIONSHIPS NOT REQUIRED

A. European Union Directive

In contrast to the precedent interpreting U.S. insider trading laws, European law explicitly seeks to achieve market fairness and transparency for investors.[106] In doing so, the E.U. expressly declared that an individual simply may not trade on insider information regardless of how such information was obtained.[107] Recognizing the endless possibilities of exploitation of confidential information in this age of the internet,[108] the E.U. has created a statutory scheme of liability more encompassing than that of the United States with respect to electronic data thieves.[109] Without any requirement of a breach of duty, the E.U. focuses instead on whether a person was merely in possession of inside information when a trade occurs.[110] The legal disposition of Dorozhko

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[104] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *16 n.6, *64.

[105] As of the date this article went to press, the Second Circuit had not yet issued an opinion on the merits of the preliminary injunction.

[106] *See* Press Release IP04/16 Market Abuse: Commission Adopts First Implementing Measures, Brussels (Jan. 7, 2004) (listing among the priorities of the EU Directive to "establish a strong commitment to transparency and equal treatment of market participants.").

[107] Council Directive 2003/6/EC, Arts. 2-4, 2003 O.J. (L 96) 21.

[108] "New financial and technical developments enhance the incentives, means and opportunities for market abuse: through new products, new technologies, increasing cross-border activities and the Internet." *Id*. at L 96/16.

[109] Of course, a scheme of liability is only as effective as the enforcement mechanism in charge of prosecuting offenses, and the existence of statutory liability does not necessarily mean offenders are held responsible. For example, between 1995 and 2000, there were only 13 successful prosecutions of insider trading violations across 17 European nations. *See infra* note 111. Each nation places differing levels of priority on prosecuting such violations, as is evidenced by the fact that the Commission's budget is almost 50 times larger than that of Germany's federal regulator. *Id*.; *see generally* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, J. OF FIN., 75–108 (2002), Table I (demonstrating the existence of insider trading laws in many nations which do not actively prosecute cases of such); *see also* Bernard Black, *The Core Institutions That Support Securities Markets*, 55 BUS. LAW. 1565, 1576–78 (2000) (arguing that viable enforcement mechanisms are critical for a strong public securities market).

[110] *See* Section IIIB, *infra*.

and others who surely will follow his example highlight this point, as E.U. law would likely impose liability for his conduct.

In January 2003, upon an overwhelming consensus on the need for clearer guidelines,[111] the E.U. published an official directive on insider trading and market manipulation for the stated purpose of promoting investor confidence ("E.U. Directive"),[112] explicitly outlining the prohibited conduct and to whom the prohibitions apply. Promulgated by the European Parliament and the Council of the E.U., this prohibition was required to be implemented in substantially similar form by each individual member nation of the E.U. ("Member State") in its own national legislation.[113] In order to effect a seamless cross-border system of enforcement, the E.U. Directive mandates that all Member States apply the requirements contained in the E.U. Directive to all actions carried out in the territory of the home state, or those actions carried out abroad when such conduct concerns financial instruments traded on a regulated market within the home state.[114] Additionally, each Member State must include in its proscription of insider dealing all relevant conduct carried out in its territory concerning financial instruments that are admitted to trading in another Member State.[115] Thus, under the E.U. Directive and the implementing legislation in each Member State, any act of insider trading occurring within any Member State is prohibited.

Unlike the United States, the E.U. has soundly rejected any requirement of a fiduciary duty in favor of a straightforward rule against an imbalance of information in securities transactions. The E.U. Directive requires that Member States prohibit those in possession of inside information from:

> (1) Using that information, by acquiring or disposing of (or attempting to acquire or dispose of) any financial instrument to which the information relates, either directly or indirectly, and either for his own account or on account of a third party ("insider dealing"); [116]

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[111] *New Curbs on Insider Trading, Market Abuse Agreed to by E.U. Parliament.* 34 SEC. REG. & L. REP. 432 (2007) (noting that the draft legislation won preliminary approval in the European Parliament by a vote of 398-3).

[112] "An integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives." Council Directive 2003/6/EC, 2003 O.J. (L 96) 16.

[113] *See* Council Decision 1999/4681/EC, 1999 O.J. (L 184) (promulgating procedures for the exercise of implementing powers conferred on the Commission).

[114] Council Directive 2003/6/EC, Art. 10(a), 2003 O.J. (L 96) 23.

[115] *Id.* at Art. 10(b), L 96/23.

[116] *Id.* at Art. 2(1), L 96/21. Where the individual involved in this situation is a legal entity, this prohibition also applies to the natural persons who partake in the decision to carry out the transaction on behalf of the legal entity involved. *Id.* at Art. 2 § 2, L 96/21.

> (2) Disclosing that information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties ("disclosing insider information");[117] or
>
> (3) Recommending or inducing another person, on the basis of such information, to acquire or dispose of financial instruments to which that information relates ("tipping").[118]

Much like the definition of material non-public information as commonly understood in the United States, inside information under the E.U. Directive is information that: (1) is precise in nature; (2) has not been made public; (3) relates directly or indirectly to a financial instrument or an issuer of such; and (4) if it were public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.[119]

Importantly, these prohibitions apply to an expansive group of persons, far beyond traditional corporate insiders, including those who possess inside information by virtue of their membership of the administrative, management or supervisory bodies of the issuer or through their employment or other professional duties, or by virtue of holding stock in the issuer.[120] The E.U. Directive also includes those who possess inside information by virtue of criminal activities.[121] In fact, the E.U. Directive explicitly stresses the importance of including those cases of insider dealing where the information at issue originates not from a profession or function, but from criminal activities.[122] Additionally, as an expansive catch-all, the directive includes as potential insiders those who knew, or should have known, that the information they possess is considered inside information—termed "secondary insiders."[123]

Entirely sidestepping any requirement for a relationship between the actor and the issuer, or the actor and the source of his information, the E.U. Directive encompasses more conduct than would be prohibited under U.S. law, notably with respect to information thieves.[124] Those,

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[117] *Id.* at Art. 3(a), L 96/21.

[118] *Id.* at Art. 3(b), L 96/21.

[119] Council Directive 2003/6/EC, Art. 1 § 1, 2003 O.J. (L 96) 23. The E.U. definition however, lacks the subjectivity contained in the U.S. definition, substituting the judgment of the "reasonable investor" for a more objectively defined effect on market price.

[120] *Id.* at Art. 2, L 96/21.

[121] *Id.*

[122] "As regards insider dealing, account should be taken of cases where inside information originates not from a profession or function but from criminal activities, the preparation or execution of which could have a significant effect on the prices of one or more financial instruments or on price information in the regulated market as such." *Id*. at L 96/17 (17).

[123] *Id.*

[124] Council Directive 2003/6/EC, Art. 2, 2003 O.J. (L 96) 21.

like Dorozhko, would qualify under both the criminal and secondary insider provisions, making conduct such as his actionable anywhere within the E.U.

Complying with the E.U. Directive, each Member State has accordingly enacted implementing legislation.[125] Because the E.U. Directive did not specify whether it applied to civil or criminal penalties or both, Member States' legislation vary on the penalties imposed. For instance, the United Kingdom promulgated criminal sanctions for insider trading violations in 1993.[126] Although the United Kingdom only established civil liability in 2000, and thereafter revised the civil scheme to comport with the guidelines of the E.U. Directive in 2003, the criminal liability system has remained unchanged.[127] Regardless of the differing penalties at stake, each of the Member States has implemented the requirements of the E.U. Directive into their legal schemes in some fashion to prohibit, among other things, insider trading.[128]

B. Implementing Legislation in European Member States

A sampling of implementing legislation in E.U. Member States illustrates how the E.U. Directive has been applied on a national level.

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[125] *See* Committee of European Securities Regulators, *Report on Administrative Measures and Sanctions as well as the Criminal Sanctions available in Member States under the Market Abuse Directive* (Oct. 17, 2007).

[126] HM Treasury, U.K. Implementation of E.U. Market Abuse Directive, June 2004 § 3.4.

[127] *Id.*

[128] *See supra* note 125.

National Legislation Implementing the European Union Directive 2003/6/EC on Insider Dealing and Market Manipulation[129*]

Austria: Financial Market Authority ("FMA")	
Civilly Liable Conduct	**Civil Penalties**
The FMA has the right to seek administrative penalties for any violation of insider trading laws as defined by the criminal law.[1]	Administrative penalties include the public disclosure of insider trading offenses.[2] Additionally, the FMA has the right to order the exchange operating company[3] to suspend trading in a financial instrument at issue in an investigation of insider dealing.[4]
Criminally Liable Conduct	**Criminal Penalties**
Any insider, whether primary or secondary, may not take advantage of inside information before the public has knowledge of the inside information, by: • buying or selling the financial instruments concerned to a third party or offering to buy or sell these to a third party, or recommending such action with the intention of gaining a pecuniary benefit for oneself or a third party ("insider dealing"); or • making this information accessible to a third party without having been ordered to do so with the intention of gaining a pecuniary benefit for oneself or a third party ("disclosure of inside information");[5] or • using such information in the manner described in paragraphs 1) or 2) with	Criminal penalties for primary insiders in violation of insider dealing or disclosure of information provisions include: • a prison sentence of up to three years, or, if the pecuniary benefit gained exceeds €50,000, a prison sentence of six months to five years.[10] Criminal penalties for secondary insiders in violation of insider dealing or disclosure of inside information provisions include: • a prison sentence of not more than one year, or, if the pecuniary benefit gained exceeds €50,000, the punishment shall be a prison sentence up to three years; or • a fine of not more than 360 times the daily fine rate as set by the court;[11] Criminal penalties for negligent insider dealing

[129] Other industrialized nations have enacted securities laws which do not require a fiduciary duty *per se* like the United States, but still require the individual to be either a corporate insider or the recipient of information from a corporate insider to assign insider trading liability. *See, e.g.,* Securities and Futures Ordinance Ch. 571, Law No. 12 of 2003, § 285 (2003) (Hong Kong); Kin'yū shōhin torihiki-hō [Financial Instruments and Exchange Law], Art. 166 (2007) (Japan); Securities and Exchange Act of 1962, Act No. 972 of 1962, Arts. 188-2, 207-2 (2005) (Republic of Korea); § 72 of Securities Services Act of 2004 (South Africa); Securities and Exchange Act Arts. 157-1, 171 (Taiwan). Australia, however, appears to be more closely aligned with the E.U. in defining an insider as a person who possesses inside information and knows, or ought reasonably to know that the information he or she possesses would be qualified as inside information. *See* Corporations Act, 2001 Div. 3 Part 7.10 § 1042 (Austl.). Thus, a "complete outsider" may be subject to liability even where there is no relationship at all to either the stockholders or the source of the information.

***** References and authorities for this comparative chart are included as endnotes following the conclusion of this article.

the knowledge or in gross negligent ignorance of the fact that the information is inside information, but without the intention to attain a pecuniary gain for oneself or a third party[6] ("negligent insider dealing"). *Primary Insider*: Any person who has access to inside information as a member of an administrative, management or supervisory body or an issuer or otherwise due to his profession, employment, duties or share in the capital of an issuer. Any person having obtained inside information through criminal acts shall also be deemed an insider.[7] *Secondary Insider*: Any person who is informed of or learns of inside information.[8] *Inside Information*: Any information of a precise nature, which has not been make public and relates directly or indirectly to one or more issuers of financial instruments or to one or more financial instruments, and its disclosure could have a significant effect on the price of said financial instruments, because said information would serve an informed investor as a basis on which to reach investment decisions.[9]	include: • a prison sentence of up to six months; or a fine of not more than 360 times the daily fine rate as set by the court.[12]

Belgium: **Banking, Finance and Insurance Commission ("CBFA")**	
Civilly Liable Conduct	**Civil Penalties**
Any person who is in possession of information that he is aware, or ought to be aware, is inside information may not: • acquire or dispose of, or try to acquire or to dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information refers, or related financial instruments);[13] • disclose that information to any person, unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;[14] or • recommend or induce a third party, on the basis of that inside information, to acquire or dispose of financial instruments to which that information refers, or related financial instruments.[15] *Inside Information*: Any information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those	Administrative penalties include a fine between €2,500 and €2,500,000. If the infringement resulted in the offender obtaining a capital gain, that maximum shall be raised to twice the capital gain, and in the event of a repeat offense, to three times the capital gain.[17]

financial instruments or on the price of related financial instruments.[16]	
Criminally Liable Conduct	**Criminal Penalties**
It is prohibited to engage in any of the insider dealing offenses as defined by the civil code.[18]	Criminal penalties include: 1) a prison sentence of between three months and one year; or 2) a fine of €50 to €10,000.[19]

France: Autorite des Marches Financiers ("AMF")	
Civilly Liable Conduct	**Civil Penalties**
Any insider, whether primary or secondary, is prohibited from: • using inside information by acquiring or disposing of, or by trying to acquire or dispose of, for his or her own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates; • disclosing inside information to another person, other than in the normal course of his employment, profession or duties, or for a purpose other than that for which the information was disclosed to him or her; • advising another person to buy or sell, or to have bought or sold by another person, on the basis of inside information, the financial instruments to which such information pertains or related financial instruments.[20] *Primary Insider*: Any person[21] holding inside information by virtue of membership of the administrative, management or supervisory bodies of the issuer; holding in the issuer's capital; access to such information through the exercise of the person's employment, profession or duties, as well as his or her participation in the preparation or execution of a corporate finance transaction; or activities that may be characterized as crimes or offenses.[22] *Secondary Insider*: Any person who holds inside information and who knows, or should know, that is inside information.[23] *Inside Information*: Any information of a precise nature that has not been made public, relating directly or indirectly to one or more issuers of financial instruments, or to one of more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of the relevant financial instruments or on the prices of related financial instruments.[24]	Administrative penalties include: • an injunction to cease wrongful practices.[25] • emergency suspension (temporary) from professional activities for regulated entities.[26] • a warning, reprimand, or temporary or permanent prohibition from providing professional services.[27] • monetary fines up to €1.5 million, or ten times the amount of any profit realized in the transaction.[28]

Criminally Liable Conduct	**Criminal Penalties**
Before the public has knowledge of privileged information, a primary insider may not: • carry out or facilitate a "transaction"[29] ("insider dealing"); or • communicate that information to a third party outside the "normal framework of his profession or his functions" ("disclosure of insider information").[30] Before the public has knowledge of privileged information, a secondary insider may not: • communicate, directly or indirectly, privileged information to a third party before the public has knowledge of the information ("secondary insider dealing").[31] *Primary Insider*: A person who, through his or her employment, obtains privileged information (either directly or through an intermediary) concerning an issuer of securities or the likely performance of a financial instrument.[32] *Secondary Insider*: Any person who knowingly obtains privileged information concerning an issuer of securities or the likely performance of a financial instrument.[33]	Criminal penalties for "inside dealing" include: • two years' imprisonment; and • a fine of up to €1,500,000. This fine may be increased by up to ten times the amount of any profit realized, and shall never be less than the amount of that same profit.[34] Criminal penalties for "disclosure of inside information" or "secondary insider dealing" include: • one year's imprisonment; and • a fine of up to €150,000.[35] If the information in question is used in the commission of a crime, such as where the person who was tipped makes a trade on the information, the tipper's sentence shall be increased to seven years' imprisonment and a fine of €1,500,000, if the amount of the profit realized is below that figure. In such a situation, the tippee would be liable for insider dealing, and would be punished accordingly, up to two years in prison, and a fine of €1,500,000 or more depending on the amount of profit realized.[36]

Germany: **Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin")**	
Civilly Liable Conduct	**Civil Penalties**
In addition to criminal sanctions, Germany imposes administrative fines upon those in violation of the provisions prohibiting the disclosure of inside information and tipping.[37]	Administrative penalties include a fine not exceeding € 50,000.[38]
Criminally Liable Conduct	**Criminal Penalties**
No person shall: • to make use of inside information to acquire or dispose of insider securities for one's own account or on behalf of another person ("insider dealing");[39] • to disclose or make available inside information to a third party without the authority to do so ("disclosure of inside information");[40] • to recommend, on the basis of inside information, that a third party acquire or dispose of insider securities, or to otherwise induce a third party to do so ("tipping").[41]	Criminal penalties include: • imprisonment up to five years;[42] or • an unlimited fine. [43]

For a person to violate either the disclosure of inside information provision, or the tipping provision, he must have become privy to the inside information: (a) by virtue of his membership of the management or supervisory body of the issuer, or as a personally liable partner of the issuer, or of an undertaking affiliated with the issuer; (b) on the basis of his holding in the capital of the issuer or a company affiliated with the issuer; (c) on the basis of his profession, activities, or "duties performed as part of his function"; or (d) on the basis of a conspiracy to perpetrate a crime. A person need not have any particular affiliation to be prosecuted for the insider dealing provision. Thus, any person who violates the insider dealing provision is criminally liable for it, no matter how he acquired the information involved. *Inside Information:* Any specific information about circumstances which are not public knowledge relating to one or more issuers of insider securities, or to the insider securities themselves, which, if it became publicly known, would likely have a significant effect on the stock exchange or market price of the security. Such a likelihood is deemed to exist if a reasonable investor would take the information into account for investment decisions.[44]	

Ireland: **Central Bank & Financial Services Authority ("CBFSA")**	
Civilly Liable Conduct	**Civil Penalties**
An insider, either primary or secondary, in possession of inside information may not, directly or indirectly, for one's own account or for the account of a third party: • use that information to acquire, dispose of, or attempt to acquire or dispose of, financial instrument about which the information relates; • disclose that information to any person unless such disclosure is made in the normal course of the exercise of the insider's employment, profession, or duties; • recommend or induce another person, on the basis of the inside information, to acquire or dispose of financial instruments to which that information relates.[45] *Primary Insider*: Anyone who possesses inside information by virtue of the person's	Administrative penalties include: • a fine of up to €2,500,000;[49] • compensation to any other party to the illegal transaction who was not in possession of the relevant information;[50] • compensation to the issuer of the relevant financial instrument for any profit the guilty party gained in the illegal transaction;[51] or • sanctions imposed by the CBFSA including: a private caution or reprimand; a public caution or reprimand; a direction disqualifying the guilty party from holding a management position or having a qualifying holding in any regulated financial service provider for an amount of time to be determined by the CBFSA; and a direction to pay the CBFSA for all or a specified part of the costs incurred in investigating and prosecuting the matter.[52]

membership in the administrative, management or supervisory bodies of the issuer of the financial instrument; the person's holdings in the capital of the issuer; having access to information through the exercise the person's employment, profession, or duties; or by virtue of the person's criminal activities.[46] *Secondary Insider*: Any person who possesses inside information and knows, or ought to have known, that such is inside information.[47] *Inside Information*: Information which is of a precise nature; relates, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments; has not been made public; and if it were made public, would be likely to have a significant effect on the price of those financial instruments or of the related derivative financial instruments.[48]	
Criminally Liable Conduct	**Criminal Penalties**
The same conduct is actionable with both civil and criminal sanctions.	If found guilty on conviction on indictment, criminal penalties include: • imprisonment for a term not exceeding ten years; • a fine of €10,000,000; or • both.[53] If found guilty on summary conviction, criminal penalties include: • imprisonment for a term not exceeding twelve months; • a fine of €5,000; or • both.[54]

Italy: Commissione Nazionale per le Società e la Borsa ("CONSOB")	
Civilly Liable Conduct	**Civil Penalties**
An insider, primary or secondary, may not: • buy, sell or carry out other transactions involving, directly or indirectly, for his own account or for the account of a third party, financial instruments using such information; • disclose such information to others outside the normal exercise of his employment, profession, duties or position; or • recommend or induce others, on the basis of such information, to carry out any of the transactions referred to in subparagraph 1). *Primary Insider:* A person who possesses inside information by virtue of his membership of the administrative, management or supervisory bodies of an	Administrative penalties include: • a sanction of between €100,000 to €15,000,000;[59] • temporary disqualification from position as corporate officer or shareholder of authorized intermediaries, market management companies, auditors and financial salesmen.[60] • an order from CONSOB to authorized intermediaries, market management companies, listed issuers and auditing firms not to use the offender in the exercise of their activities for a period of not more than three years and may request that the competent professional associations suspend the registrant from practice of the profession.[61]

issuer, his holding in the capital of an issuer, or the exercise of his employment, profession, duties.[55] Additionally, this category includes any person who possesses inside information by virtue of the preparation of execution of criminal activities.[56] *Secondary Insider*: Any person who, possessing inside information, and knowing or capable of knowing through ordinary diligence its inside nature, carries out any of the actions described above.[57] *Inside Information:* Information of a precise nature which has not been made public relating, directly or indirectly, to one or more issuers of financial instruments or one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments. This includes information a reasonable investor would be likely to use as part of the basis of his investment decisions.[58]	
Criminally Liable Conduct	**Criminal Penalties**
The same conduct is actionable with both civil and criminal sanctions.[62] Criminal law, however, does not penalize offenses by secondary insiders.[63]	I Criminal penalties for any of the proscribed activities include: • imprisonment for two to twelve years; • a fine of €40,000 to €6,000,000;[64] • confiscation of the proceeds of the crime or the profit therefrom and the funds used to commit the crime;[65] or ban from the securities profession, holding public office, or exercising powers as a director, auditor, receiver, general manager, or any other business office.[66]

United Kingdom: Financial Services Authority ("FSA")	
Civilly Liable Conduct	**Civil Penalties**
An insider may not: • deal (or attempt to deal) on the basis of inside information relating to the investment in question; • disclose inside information to another person, other than in the proper course of one's employment; or Anyone, whether or not an insider, may not: • base behavior on information not generally available to those using the market, but which, if available to a regular user of the market, would likely to be regarded as relevant to the market decisions. The behavior also must be likely to be regarded by a regular user	Administrative penalties include: • imposition by the FSA of "a penalty of such amount as it considers appropriate".[70] • a statement published by the FSA that the person or entity has engaged in such prohibited behavior.[71] Any statement published would be done in such a way as to bring it to the attention of the public.[72]

of the market as a failure to observe the standard of behavior reasonably expected of a person in his position.[67] *Insider*: Anyone who has information: (1) as a result of his membership of an administrative, management, or supervisory body of an issuer; (2) as a result of his status as a shareholder; (3) as a result of having access to the information by means of his employment; (4) as a result of criminal activities; or (4) which he has obtained by other means, and which he could be reasonably expected to know is insider information.[68] *Insider Information:* Information that: (1) is precise in nature; (2) is not generally available; (3) relates either directly or indirectly to an issuer or investment; and (4) is likely to have a significant effect on the price of related investments, if it were to be generally available.[69]	
Criminally Liable Conduct	**Criminal Penalties**
A "person having information as an insider" may not: • deal in securities that are price-affected securities in relation to the information, on a regulated market, through a professional intermediary, or as a professional intermediary; • encourage another person to deal in price-affected securities in relation to the information, having reasonable cause to believe that the dealing would take place on a regulated market or through a professional intermediary; • disclose the information to another person, other than in the proper performance of one's employment.[73] *Person Having Information as an Insider:* A person who knows that the information he possesses would be considered inside information, and either he or his source (which can be direct or indirect) obtained such information from being a director, employee, or shareholder of a securities issuer, or from having access to the information by virtue or his employment or profession.[74] *Inside Information:* Information which: (1) relates to particular securities or issuers of securities (or that issuer's business prospects); (2) is specific or precise in nature; (3) has not been made public; and (4) if it were to be made public, would be likely to have a significant effect on the price or value of securities.[75]	If found guilty on conviction on indictment, criminal penalties include: • a fine; • a term of imprisonment up to seven years; or • both.[76] If found guilty of insider dealing on summary conviction, criminal penalties include: • a fine; • a term of imprisonment up to 6 months; or • both.[77]

IV. IMPLICATIONS IN UNITED STATES ENFORCEMENT

In contrast to European law, U.S. courts focus on the existence of some form of fiduciary relationship rather than market fairness, creating a conspicuous hole in the enforcement of insider trading laws. The regime has created the paradoxical situation wherein an individual who has obtained material non-public information in a *legal* manner may be held criminally and civilly liable for trading on such information, while one who has obtained the information in an *illegal* manner is entirely free of U.S. insider trading liability. This anomaly, labeled by Judge Buchwald in her *Dorozhko* opinion as the "inconvenient truth" of our securities laws,[130] has been and will continue to be exploited by information thieves who apparently can trade on such information without fear of reproach under Section 10(b) and Rule 10b-5 liability.[131] In this age of the internet, where information can be broadcast around the world with the click of a button, or accessed by hackers skilled enough to steal the information prior to broadcast, this loophole will continue to be exploited.

In recent years, the Commission has brought suit in at least one other instance in which it alleged that individuals acquired and exploited material non-public information through acts of electronic theft.[132] In *SEC v. Lohmus Haavel & Viiseman*, the Commission alleged that individual defendants Peek and Lepik, employees of co-defendant Lohmus Haavel & Viisemann, an Estonian financial services firm, were engaging in a fraudulent scheme using a "spider" program to troll for secure, password-protected confidential information through the website of Business Wire, a leading distributor of regulatory filings and news releases for companies throughout the world.[133] Through their electronic activity, the defendants were alleged to have accessed more than 360 confidential press releases about mergers, earnings announcements and regulatory actions, from more than 200 public companies.[134] This

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[130] *Dorozhko*, 2008 U.S. Dist. LEXIS 1730, at *5.

[131] Such hackers may still be liable under mail or wire fraud, and the Computer Fraud and Abuse Act. *See* Section IID. These charges, however, would need to be pursued by the United States Department of Justice ("DOJ"), not the Commission. Although a crime may have been committed in the actual theft of the information, the trade itself, as discussed in this article, is not actionable.

[132] SEC v. Lohmus Haavel & Viiseman, No. 05-9259, 2005 WL 3309748 (S.D.N.Y. 2005).

[133] SEC Litigation Release No. 19450 (Nov. 1, 2005), *available online at* http://www.sec.gov/litigation/litreleases/lr19450.htm (last visited June 5, 2009); Complaint in SEC v. Lohmus Haavel & Viisemenn, No. 05-CV-9259, (Nov. 1, 2005), *available online at* http://www.sec.gov/litigation/complaints/comp19450.pdf (last visited June 5, 2009).

[134] *Id.*

information allegedly enabled the defendants to "strategically time" their stock positions around the public release of their previously acquired information, resulting in gains in the millions of dollars.[135] The Commission's allegations relied entirely on violations of Section 10(b) of the Exchange Act and Rule 10b-5.[136]

Ultimately, without admitting or denying the Commission's allegations, the defendants reached a settlement in which Peek and Lepik agreed to disgorge $13,000,000 and $566,958, respectively, representing their ill-gotten gains from the alleged scheme, in addition to civil penalties of $1,350,000 and $15,000 respectively.[137] Additionally, Lohmus, Haavel & Viiseman consented to a civil penalty of $650,000.[138]

Despite this apparent victory for the Commission, the subsequent and explicit precedent of *Dorozhko* will open the door for future information thieves to exploit this method of profitable trading. Stories already are appearing on the Internet, advertising the ease with which profits can be made in this way, and the unlikelihood of federal charges or civil claims based on insider trading.[139] The fact remains that those who obtain material non-public information in a lawful manner may be held liable for a subsequent trade on such information, while those who actively and criminally steal such information and perform the same trade are entirely free from insider trading liability, is a contradiction which will continue to be exploited. Such a paradox effectively has been remedied by European jurisdictions, whose laws close this loophole.

Commentators have argued that the Commission could promulgate further regulations interpreting Section 10(b) to define more explicitly the boundaries of prohibited conduct.[140] Regulations issued by the Commission as an administrative agency of the Executive Branch, however, may not extend beyond the confines of Section 10(b) itself in terms of scope or authority, as set by Congress and defined by the judiciary.[141] Given the Supreme Court's explicit determination that the

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[135] *Id.*

[136] *Id.*

[137] SEC Litigation Release. No. 20134 (May 31, 2007) *available online at* http://www.sec.gov/litigation/litreleases/2007/lr20134.htm; SEC Litigation Release No.19810 (Aug. 22, 2006), *available online at* http://www.sec.gov/litigation /litreleases/2006/lr19810.htm (last visited June 5, 2009).

[138] *Id*.

[139] *See, e.g.,* How to Beat an Insider Trading Rap at IB, http://www.elitetrader.com/ vb/showthread.php?threadid=132761 (last visited June 5, 2009); Gaming the Market: How to Beat an Insider Trading Rap, http://www.gamingthemarket.com/2008/06/how-to-beat-an-insider-trading-rap.html) (last visited June 5, 2009).

[140] *See* Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 611 (2008) (arguing that the Commission could promulgate another rule pertaining to insider trading liability in the context of illegally obtained information, more clearly specify the bounds of the prohibition, or create a "general parity-of-access rule").

[141] *O'Hagan*, 521 U.S. at 651 ("Liability under Rule 10b-5 . . . does not extend beyond conduct encompassed by § 10(b)'s prohibition."); *Ernst & Ernst*, 425 U.S. at

Exchange Act mandates a fiduciary duty, it is unlikely that a Commission rule could withstand judicial scrutiny should it go so far as to extend liability over those defendants with no fiduciary relationship at all.

Similarly, short of an outright reversal by the Supreme Court, judicial interpretation disposing of the fiduciary duty requirement is unlikely to pass scrutiny. The Second Circuit currently has the opportunity to diverge from precedent in finding Dorozhko liable for his trades despite his lack of any duty to either the issuer or source of information. Such an action, however, is unlikely given the explicit instructions of the Supreme Court as discussed in Section II. Even if the Second Circuit takes a renegade approach in moving toward a scheme of market fairness under the Exchange Act as it did in *Chiarella*,[142] it is likely the Supreme Court's reaction would be the same in rejecting "a general duty between all participants in market transactions to forego actions based on material non-public information."[143]

Of course, Congress itself could take action in updating Section 10(b) to clarify the law and dispose of the fiduciary requirement.[144] As discussed in Section II above, the Exchange Act itself was largely a reaction to the perceived corruption in the securities markets. In another era of several high profile insider trading scandals during the eighties, a bill entitled the "Insider Trading Proscriptions Act of 1987" was proposed by Senators Alfonso D'Amato (R-N.Y.) and Donald Riegle (D-Mich.),[145] which would have codified an expanded definition of insider trading.[146] The definition would have explained that "information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion,

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213–14 (internal quotations omitted) ("Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.").

[142] *Chiarella,* 588 F.2d at 1362.

[143] *Chiarella*, 445 U.S. at 233.

[144] *See* Richard W. Painter, Kimberly D. Krawiec, and Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998)(explaining that confusion surrounds the requirement of "fiduciary duties having nothing to do with corporate law," and that lack of clear definitions in the enforcement scheme should be remedied by an amendment to Section 10(b)); John I. McMahon, Jr., *A Statutory Definition of Insider Trading: The Need to Codify the Misappropriation Theory*, 13 DEL. J. CORP. L. 985, 1026 (1988) (arguing that, in the wake of the failed Insider Trading Proscriptions Act of 1987 and the Commission's accompanying proposals, a definitive legislative statement is necessary to clarify the law).

[145] Roberta S. Karmel, *Insider Trading: Law, Policy, and Theory after O'Hagan: Outsider Trading on Confidential Information—a Breach In Search of a Duty*, 20 CARDOZO L. REV. 83, 98–101 (1998) (explaining statutory developments pertaining to insider trading law throughout the 1980's).

[146] S. 1380, 100th Cong. (1987) *reprinted in* S. Hrg. 100-155, pt. 1, at 74 (1987).

misappropriation or a breach of fiduciary, contractual, employment, personal, or other relationship of trust and confidence."[147]

The Commission objected to this definition, concerned that it would limit its enforcement powers.[148] The Commission responded with its own proposed "Insider Trading Act of 1987,"[149] stating that "[t]he fairness, efficiency and integrity of the nation's securities markets are impaired when corporate insiders or other persons who obtain material non-public information relating to an issuer or its securities wrongfully trade, or wrongfully cause the trading of, securities while in possession of that information."[150] With this goal, the Commission proposed that Section 10(b) be amended by adding that "[i]t shall be unlawful for any person, directly or indirectly, to purchase [or] sell . . . any security while in possession of material non-public information concerning the issuer or its securities, if such person knows or recklessly disregards that such information has been obtained" through a breach of duty,[151] or, most notably, through "theft, bribery, misrepresentation, or espionage through electronic or other means."[152] Following Congressional hearings, the Commission submitted a revised bill with similar language,[153] but the

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[147] *Id.*

[148] *See* Steinbuch, *supra* note 140, at 612.

[149] *Text of Draft "Insider Trading Act of 1987" submitted by SEC,* 19 Sec. Reg. & L. Rep. (BNA) 1284 (Aug. 14, 1987).

[150] *Id.* at § 2(1).

[151] Such duty may arise from any fiduciary, contractual, employment, personal or other relationship with: (a) the issuer of the security or its security holders; (c) any person planning or engaged in an acquisition or disposition of the issuer's securities or assets; (c) any government, or a political subdivision, agency or instrumentality of a government; (d) any person, or any self-regulatory organization, registered or required to be registered with the Commission under any provision of the federal securities laws; (e) any person engaged in the business of gathering, analyzing, of disseminating information concerning securities, the markets for securities, or the financial condition of issuers; (f) any other person that is a member of a class that the Commission designates, by rule or regulation, where the Commission finds (i) that the activities of the members of such class have a regular nexus to the operation of the nation's securities markets, and (ii) that such designation is necessary or appropriate to effectuate the purposes of this Section; or (g) any other person who obtained such information as a result of a direct or indirect confidential relationship with any of the persons or entities referred to in the previous categories. *Id.* at § 3(a)(2).

[152] *Id*. at § 3(a)(1).

[153] 19 SEC. REG. & L. REP. (BNA) 1817 (Nov. 27, 1987), Section (b)(1) ("It shall be unlawful for any person, directly or indirectly, to purchase, sell, or cause the purchase or sale of, any security, while in possession of material, non-public information relating thereto, if such person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information. For the purposes of this subsection, such trading while in possession of material, non-public information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery misrepresentation, espionage (through electric or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.").

definition proved too controversial, and no further steps were taken with respect to the bill.[154] No further attempts by Congress or the Commission have been made to update the laws since. The proposed definitions, however, are remarkably similar to those eventually adopted by the E.U., and would have covered cases such as *Dorozhko* and *Blue Bottle*.

As with the Exchange Act, the proposed Insider Trading Proscriptions Act, and the recent and hotly-debated Sarbanes-Oxley Act, promulgated in the wake of a mass of corporate scandals, the slow but heavy hand of Congress waits for public outrage at corporate corruption to push it into action.[155] Whether cases such as *Dorozhko*, or more likely those who will inevitably follow his lead to garner far larger profits, will incite public outcry remains a question for the future. In the meantime, in stark contrast to the laws of the E.U., the winding path of judicial interpretation in the United States will continue to "define" insider trading based on the existence of a fiduciary duty until Congress adopts legislation substantially similar to its previous proposals, or which at least includes more clearly delineated definitions.[156]

V. CONCLUSION

In conclusion, given the enduring requirement of a breach of duty under Section 10(b) of the Exchange Act, as discussed in Section II *supra*, the case of *SEC v. Dorozhko* illustrates the gap in U.S. insider trading liability through which "true outsiders" of a company may not be

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[154] *See* Karmel, *supra* note 145, at 100. Controversy over whether the statutory definition of insider trading should be limited to prohibiting one from "use" of the information in trading or merely "possession" of it resulted in deadlock, and no definition was created. Thomas Lee Hazen, *United States v. Chestman—Trading Securities on the Basis of Nonpublic Information in Advance of a Tender Offer*, 57 BROOK. L. REV. 595, 615 (1991).

[155] Erica Beecher-Monas, *Enron, Epistemology, and Accountability: Regulating in a Global Economy*, 37 IND. L. REV. 141, 144 (2003) ("In response to these corporate debacles (and to Enron in particular), Congress passed the Sarbanes-Oxley Act."); Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 632 (December 2003) (noting that the passage of the Sarbanes-Oxley Act was a reaction to "Enron-era scandals"); Robert Wright, *Enron: The Ambitious and the Greedy*, 16 W.R.L.S.I. 71, 72 (2003)("As it turns out, Enron and the high-risk accounting practices that allowed it to inflate shareholder equity by $ 1.2 billion was just the tip of the iceberg; similar scandals were soon discovered at WorldCom and Global Crossing. And the corporate malfeasance did not stop there: some 250 American public companies will have to restate their accounts this year, compared with only 92 in 1997 and three in 1981. The United States Congress responded. The Sarbanes-Oxley Act became law in July 2002, making sweeping changes to American securities law . . . .").

[156] "Virtually every other country that has joined the United States in prohibiting trading on the basis of material, non-public information has done so through statutes that define with specificity such terms as "insider" and "inside information" as well as the circumstances in which trading is prohibited . . . The United States stands alone in allowing judges to develop a common law prohibition against insider trading." *Painter* et. al, *supra* note 144, at 210.

held accountable for trading on material non-public information. To the contrary, the E.U. recently imposed a scheme of general fairness in the marketplace, focusing on the imbalance of information when a trade occurs rather than any specific relationship between the parties involved and the issuer, as discussed in Section III *supra*. Until the Supreme Court expands its previous interpretation or Congress acts to amend and update the law, data thieves in the U.S. may continue to steal and trade on material non-public information without fear of reprisal under the Exchange Act.

National Legislation Implementing the European Union Directive 2003/6/EC on Insider Dealing and Market Manipulation Reference and Authority

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[1] Austrian Stock Exchange Act Art. 48q.

[2] *Id*. at Art. 48q(4).

[3] The exchange operating company may be any legal entity that manages and/or operates a regulated market or anyone who operates any other securities exchange or general commodities exchange. *Id.* at Art. 2.

[4] *Id.* at Art. 48q(3).

[5] *Id.* at Art. 48b(1).

[6] *Id.* at Art. 48b(3).

[7] Austrian Stock Exchange Act 48b(4). In the case of a legal entity, those natural persons shall be considered insiders who were involved in the decision to carry out a transaction for the account of the legal entity. *Id*.

[8] *Id.* at Art. 48b(2).

[9] *Id*. at Art. 48a(1)(1).

[10] *Id.* at Art. 48b(1).

[11] *Id.* at Art. 48b(2). A "daily rate" is determined based on the economic circumstances of the perpetrator and can be set between €2 and €500. Austrian Penal Code Art. 19(2).

[12] Law on the Supervision of the Financial Sector and on Financial Services, Chapt. II, Art. 48(3).

[13] *Id*. at Art. 25 § 1(a). Where the individual involved in this situation is a legal entity, this prohibition also applies to the natural persons who partake in the decision to carry out the transaction on behalf of the legal entity involved. *Id*. at Art. 25 § 2.

[14] *Id.* at Art. 25 § 1(b).

[15] *Id.* at Art. 25 § 1(c).

[16] Law on the Supervision of the Financial Sector and on Financial Services, Chapt. II, Art. 2 § 14.

[17] *Id.* at Art. 36 § 2.

[18] *Id.* at Art. 40 §§ 1–3.

[19] *Id.* at Art. 43; Committee of European Securities Regulators, *Report on Administrative Measures and Sanctions as well as the Criminal Sanctions available in Member States under the Market Abuse Directive* (Oct. 17, 2007). An offender also may be ordered to pay a fine of up to triple the capital gain that he has obtained through his infringement. *Id.*

[20] Law on the Supervision of the Financial Sector and on Financial Services, Chapt. II, Art. 622-1.

[21] Where the person is a legal person, the described prohibitions also apply to natural persons taking part in the decision to effect the transaction on behalf of such legal person. *Id*. at Art. 622-2.

[22] *Id*.

[23] *Id*.

[24] *Id*. at Art. 621-1. Information is deemed to be precise if it indicates a set of circumstances or event that has occurred or is likely to occur and a conclusion may be drawn as to the possible effect of such set of circumstances or event on

the prices of financial instruments or related financial instruments. Information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments is information that a reasonable investor would be likely to use as part of the basis of his investment decisions. *Id*.

[25] Monetary and Financial Code (2005) L621-14. Like the SEC power within the United States, the AMF may order a person to cease all practices contrary to the laws of regulations intended to protect investors from insider trading. This decision can be made public. *Id.*

[26] *Id.* at L621-15. During AMF enforcement proceedings, the AMF Board may suspend the professionals involved in the investigation (which includes legal entities, and the natural persons who work on their behalf). *Id.*

[27] *Id.* at L621-15 III. The sanction decision may be published. *Id.*

[28] *Id.* at L621-15 III. The monetary penalty involved is to be "commensurate with the seriousness of the breaches committed and any advantages or profits derived from those breaches." *Id*.

[29] Monetary and Financial Code (2005) at L465-1. Although the code itself does not specify that the transaction must be related to the privileged information the individual possessed at the time, this is assumed by practitioners in France. Bender, Doing Business in France §14.05 (2007).

[30] Monetary and Financial Code (2005) at L465-1.

[31] *Id.* at L465-3.

[32] *Id*. at L465-1.

[33] *Id*.

[34] *Id.* at L465-1.

[35] Monetary and Financial Code (2005) at L465-1.

[36] *Id*.

[37] Securities Trading Act ("WpHG") § 39(2) no.3-4. Here, there is no requirement of any particular affiliation (to the issuer, through the person's employment, or to a conspiracy), as is required to violate the criminal counterparts of these laws.

[38] *Id.* at § 39.

[39] *Id.* at § 14(1) no. 1. Violation of the insider dealing provision can be prosecuted for a negligent state of mind. *Id.* at § 38(4). However, the punishment imposed for violations of intentional insider dealing can be up to five times higher than merely negligent conduct. *Id.* at § 38(1) no.1.

[40] *Id.* at § 14(1) no. 2. It should be noted that the provisions prohibiting the disclosure of inside information and tipping require an intentional act. *Id.* at § 38 (1) no. 2.

[41] *Id.* at §14(1) no. 3.

[42] If, however, an offence is committed through negligence, the punishment shall not exceed one year in prison or a criminal fine. Monetary and Financial Code (2005) at § 38(4).

[43] *Id.* at § 38.

[44] *Id.* at §13(1). Information is "likely to have a significant effect on the stock exchange or market price" when a reasonable investor would take the information into account for investment decisions. *Id.* at §13(1).

[45] *Id.* at §§ 5(1)-(2). This prohibition does not apply to any transaction conducted in the discharge of an obligation to acquire or dispose of any financial instrument, which has become due, and results from an agreement concluded before the person concerned came into possession of the relevant inside information. *Id.* at § 5(5).

[46] *Id.* at § 5(3)(a). If the person falling into any of the above four categories is a legal entity, then any natural person who takes part in the decision to carry out, for the account of the legal entity, any transaction in financial instruments is also considered an insider. *Id.* at § 5(3)(b).

[47] Monetary and Financial Code (2005) at § 5(3)(c).

[48] *Id.* at § 2(1).

[49] Monetary and Financial Code (2005) at § 41(c).

[50] Investment Funds, Companies and Miscellaneous Provisions Act 2005, § 33(1)(a). The guilty party shall pay for any loss sustained by the counterparty by reason of a difference between the price at which the relevant financial instruments were traded and the price at which they would have been likely to have been traded if the relevant information was generally available. *Id.*

[51] *Id.* at § 33(1)(b).

[52] Irish Market Abuse Law, § 41.

[53] Investment Funds, Companies and Miscellaneous Provisions Act 2005, § 32.

[54] Irish Market Abuse Law, § 49.

[55] Unified Financial Act Art. 187-bis(1).

[56] *Id.* at Art. 187-bis(2).

[57] *Id*. at Art. 187-bis(4).

[58] *Id*. at Art. 181(1)-(4).

[59] *Id.* at 187-bis(1); Art. 39(3) of Law 262/2005. The fine may be increased by three to ten times the product of the offense or the profit therefrom when the maximum fine appears inadequate in view of seriousness of the offense, the personal situation of the guilty party, or the magnitude of the product of the offense or the profit therefrom. Unified Financial Act, Art. 187(2). Pecuniary administrative sanctions for insider trading always include the confiscation of the product of the offense or the profit therefrom and the property used to commit it. If it is not possible to recover the proceeds or profit, a sum of money or property of equivalent value may be confiscated. Unified Financial Act, Art. 187(6).

[60] Unified Financial Act at Art. 187(4).

[61] *Id.*

[62] *Id.* at Art. 184.

[63] *Id.*

[64] *Id.* at Art. 184(1); Art. 39(1) of Law 262/2005. The fine may be increased by the court to three to ten times the product of the crime or the profit therefrom when the maximum fine appears inadequate in view of the seriousness of the offense, the personal situation of the guilty party, or the magnitude of the product of the crime or the profit therefrom. Unified Financial Act, Art. 184(3).

[65] Unified Financial Act Art. 187. Where it is not possible to recover the proceeds or profit, a sum of money or property of equivalent value may be confiscated. *Id.*

[66] *Id.* at Art. 186. These accessory penalties remain in force for between six months and two years. C.P. Book I, Title II, Chapter II, Section III, Art. 28, 30, 32(2), 32(3).

[67] Financial Services and Markets Act of 2000, Ch. 8 § 118. The conduct is proscribed whether it occurs in relation to a person's affirmative action or inaction. *Id*. at § 130A(3).

[68] *Id.* at § 118B.

[69] *Id.* at §§ 118C(1)-(2).

[70] *Id.* at § 123. In deciding the proper penalty, the FSA looks to whether the conduct had an adverse effect on the market, the extent to which the conduct was deliberate or reckless, and whether the guilty party is a person or business entity. *Id.* at § 124.

[71] Financial Services and Markets Act of 2000, Ch. 8 § 123(3).

[72] *Id.* at § 124(7).

[73] Criminal Justice Act 1993, Ch. 36 § 52.

[74] *Id.* at § 57(2).

[75] *Id.* at §§ 56(1); 60(4).

[76] *Id.* at § 61(1)(b).

[77] *Id.* at § 61(1)(a).