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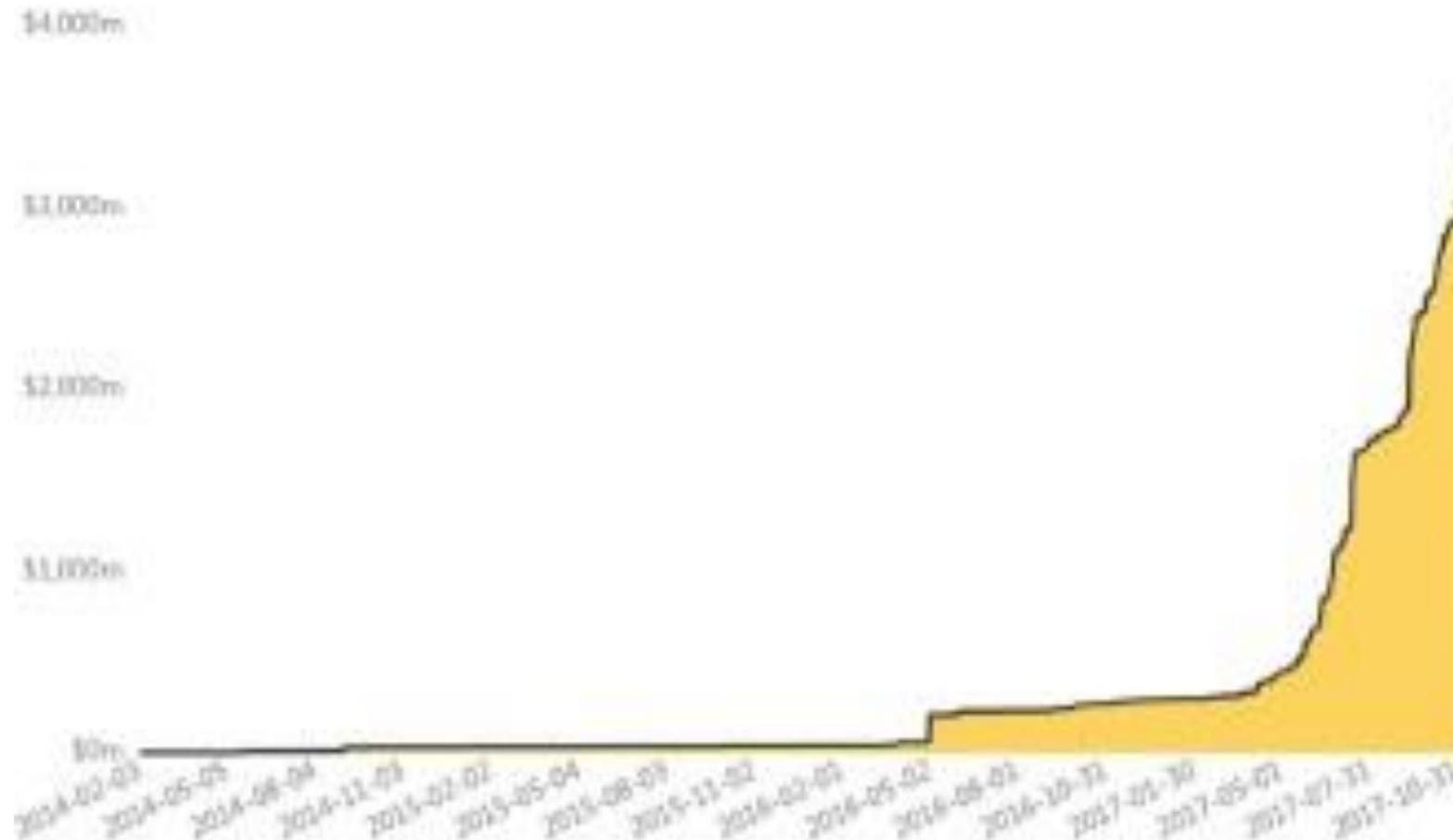
# Insider Trading, Market Manipulation in US & EU

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# All-time cumulative funding raised in ICOs



Source: CoinDesk ICO Tracker, November 2018

# ICOs: Four Different Regulatory Approaches



Temporary  
ban on ICOs



Requirement  
of  
compliance  
with  
securities  
regulation



Requirement of  
compliance with  
securities  
regulation  
→ But clarifying  
position as to how  
to fall outside the  
scope of securities  
regulation



Current lack  
of clear  
regulatory  
treatment

prudent

liberal

# The Scope of Securities Regulation

## US

- Application of securities regulation if tokens are investment contracts: “Howey Test” (SEC v Howey)
- Investment of money → assets
- Expectation of profits
- Common enterprise
- Profit depending on the efforts of a promoter or third party

## Singapore

- Application of securities regulation if tokens are capital markets products
  - Securities
  - Futures contracts
  - Contracts or arrangements for purposes of leveraged foreign exchange trading

## Switzerland

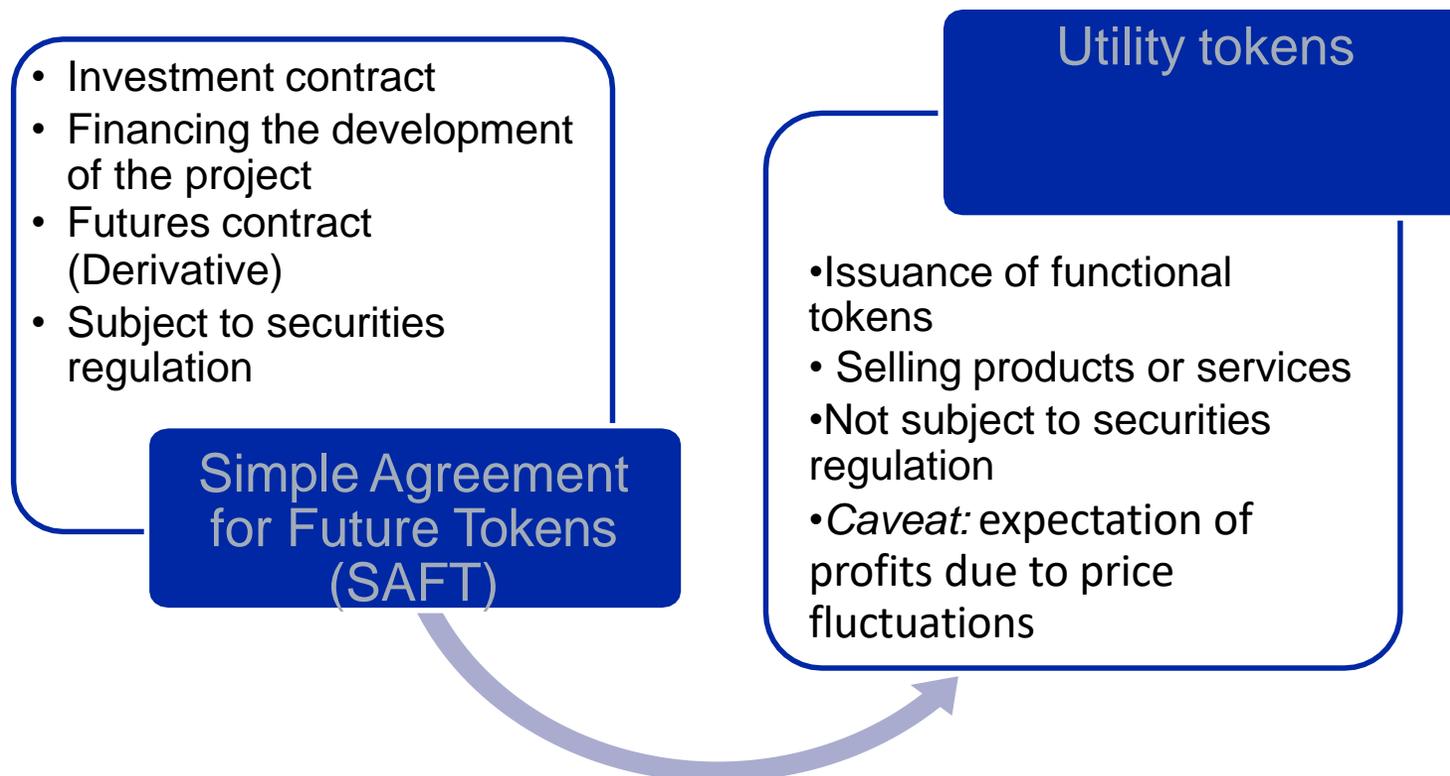
- Application of securities regulation if tokens fall within one of these 4 categories:
  - Certificated securities
  - Uncertificated securities
  - Derivatives
  - Intermediated securities (art. 2 let. b FMIA)

+ FinTech Regulatory Sandboxes

# Security vs Utility Tokens

Security tokens: Issuers raise capital through an ICO in order to finance the development of a project

Emerging business model with a view to avoiding the qualification as security tokens:



# Key Questions

- What is insider dealing?
- What is inside information?
- Who are the “insiders”?
- What are they prohibited from doing?
- What is the rationale for the prohibition? Is it justified?
- What are mechanisms used for preventing insider dealing?
- What are the enforcement mechanisms?
- Which are the remedies available for investors?
- What are the main differences between the EU and US approach?



**Corporate  
(Inside)  
Information**

**Insider Trader**

**Outside  
Information**

**Outsider Trader**

# Theories

- **Relationship-Based Rationale**

- A breach of the fiduciary relationship of trust and confidence, where one can be established, between typically, the insider and the Company concerned.
- But what happens when someone trades on the basis of inside information but does not owe a fiduciary duty to his counterparty?
- A creative adjustment of the parameters of fiduciary relationships allowed for bringing into the ID prohibition persons other than the traditional corporate insiders.
- (This became the misappropriation theory, where the wrongdoer acts on the basis of information which is acquired through any fiduciary relationship and which is intended to be confidential. This theory is based on breach of a duty owed to the person from whom the information was obtained.)

# Misappropriation Theory

- Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.
- The obligation [to disclose or abstain from trading] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. (equal access to information theory)

# Rule 10b-5

- It shall be unlawful for any person...
  - To employ any device, scheme, or artifice to defraud,
  - To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
  - To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
- in connection with the purchase or sale of any security.
- Courts found an implied private right of action in the hands of injured investors (*Kardon v National Gypsum Co.*, 1946) to recover damages for fraudulent conduct prohibited by Rule 10b-5. The law on insider trading was developed on the case law relating to this implied private right of action

# William Speed et al v Transamerica Corporation et al (1956)(relationship-based theory)



“Defendant, by reason of its control over the board of directors of Axton-Fisher, was under a fiduciary obligation to the minority stockholders of Axton-Fisher to act with fairness towards them”

“The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.”

“The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction.”

“Defendant's breach of its duty of disclosure accordingly can be viewed as a violation of all three subparagraphs of the Rule 10b-5”.

# US SEC v Texas Gulf Sulphur Co et al



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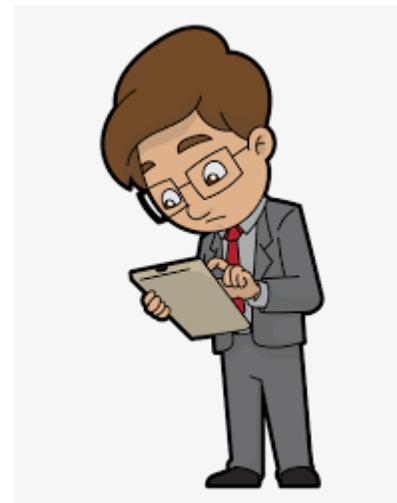
# US SEC v Texas Gulf Sulphur Co et al

- Not only directors or management officers, but anyone in possession of material inside information is an insider and must either disclose it to the investment public, or, if he chooses not to do so, must abstain from trading in or recommending securities concerned while such inside information remains undisclosed.
- Basic test in determining whether inside information is “material”: whether a reasonable man would attach importance to information in determining his choice of action in transaction in question, and that encompasses any fact which in reasonable and objective contemplation might affect value of corporation's stock or securities

# Chiarella v. United States



# Dirks v. SEC



Mr. Sacrist



Mr. Dirks

## Dirks v. SEC (US 1983)

... a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Whether the "tip" was a breach of the insider's fiduciary duty [depends on] whether ... the insider receives a direct or indirect personal benefit that will translate into future earnings.



Justice Lewis Powell

# United States v Newman

## Supreme Court - 2015

- Supreme Court refused to grant review of the Second Circuit's restrictive insider-trading decision in United States v. Newman.
- The US Government's prosecutors had asked the Supreme Court to clarify the nature of the "personal benefit" that a tipper must receive in order to create liability for insider trading. But the Supreme Court declined to take the case.
- A successful insider dealing prosecution against either the 'tipper' or 'tippee' must show that the 'tipper' received a 'personal benefit' - monetary or non-monetary - for providing inside information to a tippee.
- The Newman court defined 'personal benefit' narrowly. (not friendship nor wider non-property benefit)

# United States v O'Hagan (1997)

- A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating §10(b) Securities Exchange Act 1934 and Rule 10b-5.
- A corporate "outsider" violates §10(b) and Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades.
- Because undisclosed trading on the basis of misappropriated, nonpublic information both deceives the source of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence.

# Liability Criteria - Overview

- For an insider to be guilty of sharing inside information, his leak must breach a duty to keep the information confidential
- + He must receive a personal benefit
- The Person who receives the information must generally know of that breach and benefit
  
- Question:
- Does the insider receive a personal benefit by helping a family member?

# Salman v United States

## Supreme Court – 2016 No. 152-628

- Mr. Salman placed profitable stocks trades based on confidential information leaked by his future brother-in-law, Maher Kara
- Mr. Kara did not receive any benefit in exchange for the information
- Mr. Salman's argument for overturning his conviction hinges on the Newman decision, which narrowed the definition of a personal benefit
- The 9th circuit cited, however, a passage of the older Dirks Decision (Sup Court), that allowed liability «when an insider makes a gift of confidential information to a trading relative or friend»



# European Insider Dealing & Market Manipulation Law

# Rationale for Prohibiting Insider Dealing

- **Market-Driven Approach**
- It looks at the wider securities markets and the impact that trading on the basis of IDIF may have on the efficiency of price formation, market liquidity and on market development.
- ID undermines investor confidence about market fairness, equal opportunity to access information. If investor confidence is compromised, liquidity can be damaged and the cost of capital will increase as investors price in the risk of trading against IDIF.
- Market integrity & market integration equal access to information theory.

# Market Abuse Regulation (MAR) - Summary

- Insider dealing prohibited
- Market manipulation prohibited e.g.
  - trades that give false or misleading signals
  - trades that secure prices at an abnormal level
  - dissemination of false information through the media including the internet
- Issuers must disclose inside information to the public as soon as possible.
- Issuers must keep a list of persons with access to inside information. Managers of issuers must disclose when they trade in shares of the company.
- Firms must report suspicious transactions to their regulator

# Inside information (MAR Art. 7)

- The MAR defines 'inside information' as information which is:
- 'of a precise nature'
- has not been made public
- relates to one or more issuers of financial instruments, and
- if the information were made public, it would be likely to have a significant effect on the prices of those financial instruments.

# Information of a precise nature - Art. 7(2)

- **‘[...] information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments or the related derivative financial instrument, the related spot commodity contracts, or the auctioned products based on the emission allowances.’**

# Insiders (MAR 2014)

- **Primary Insiders** - Art. 2 Any person who possess inside information...
  - by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or
  - by virtue of his holding in the capital of the issuer; or
  - by virtue of his having access to the information through the exercise of his employment, profession or duties; or
  - by virtue of his criminal activities.
- **Secondary Insiders** - Art. 4 Any person, other than the persons referred to in those Articles, who possesses inside information while that person knows, or ought to have known, that it is inside information.

# Prohibitions (also under MAR 2014)

- Art. 2 Member States must prohibit a primary insider who possesses IDIF from...
- **Dealing:** using IDIF by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, FIs to which that information relates
- **Disclosing** inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties (Grongaard case)
- **Recommending or inducing** another person, on the basis of IF, to acquire or dispose of financial instruments to which that information relate (i.e. “tipping”)
- Art. 4 extends prohibitions to persons who possess IDIF and know or ought to have known that is IDIF

# Insider Dealing – Art. 8.1

- For the purposes of this Regulation, insider dealing arises where a person
  - **possesses inside information** and
  - **uses that information** by
  - **acquiring or disposing** of, for its own account or for the account of a third party, directly or indirectly,
  - **financial instruments** to which that information relates.
- The use of inside information by
  - **cancelling or amending** an order concerning a financial instrument to which the information relates where the
  - order was placed **before the person concerned possessed the inside information**,
  - shall also be **considered to be insider dealing**.

# Prohibitions: Dealing ( Mar 2014)

- Strict liability regime: i.e. **proof of intention is not required**
  - (ID Directive regime limited the scope of the prohibition to where the primary insider ‘took advantage’ of the inside information ‘with full knowledge of the facts’)
- Any leak of inside information can attract **both criminal and civil liability** - depending on the level of mental culpability of the tipper in leaking the inside information, and the tipper does not have to receive any personal benefit for leaking the information.
- **Causal connection between IDIF and Dealing**: the word “using IDIF” suggest a causal connection between IDIF and Dealing. It appears that the Directive does not prohibit dealing alone, while in possession of IDIF.

# Market Manipulation – MAR Art 12(1)(a)

- Entering into a transaction
  - placing an order to trade
  - Any other behavior
1. which gives or is likely to give **false or misleading signals**:
    - As to supply of, demand of, or for the price of:
    - A financial instrument,
    - A related spot commodity contract
    - an auctioned product based on emission allowances
  2. Secures or is likely to secure, the price of one or several:
    - financial instruments
    - related spot commodity contracts
    - auctioned products based on emission allowances At an abnormal or artificial level

# Preventive Mechanisms (MAR)

- Ongoing duty of issuers to disclose - as soon as possible - IDIF **which directly concerns the said issuer**
- Issuers' duty to draw up a list of insiders who have access to IDIF
- Duty of persons discharging managerial responsibilities within an issuer of financial instruments (and persons closely associated with them) to notify the competent authority transactions conducted on their own account relating to shares of the said issuer (or to derivatives or other financial instruments linked to them). Duty of disclosure of members of board of directors to disclose inside information, even if they do not trade on basis of IF.
- Duty of any person professionally arranging transactions in FIs who reasonably suspects that a transaction might constitute ID or market manipulation to notify the competent authority without delay

# Enforcement – MAR – the challenges

- EU law falls short on harmonising enforcement mechanisms other than...
  - Minimum supervisory and investigatory powers of CA
  - Administrative Sanctions that are effective, proportionate and dissuasive + right of appeal before a court
  - Silent on private remedies
  - Duty of competent authorities to co-operate with each other
- Challenges
  - ID is notoriously difficult to enforce
  - Differences between MSs in the range of sanctions available to the authorities, procedures and protections applicable to enforcement actions and lack of consistency in their application

# MAD's gaps/weaknesses – Market Abuse Regulation 2016

- Initial focus of MAD was on regulated markets
- Growth of over the counter trading, new platforms, high frequency trading and commodity derivatives.
- Hedge Funds
- High-frequency trading (flash orders) and algorithmic trading
- Dark pools
- Regulators required to impose more harmonised criminal and civil sanctions for market abuse/ manipulation.
- ESMA - need for single rulebook
- Also, should address administrative burdens, especially for SMEs: Negative impact on market integrity and investor protection, unlevel playing field and disincentives for SMEs to access securities markets

# MAR 2016

- Extends scope to cover other types of trading - instruments only traded on multilateral trading facilities, organised trading facilities & over the counter trading
- Ensures derivatives clearly in scope if used for manipulative purposes e.g. Credit Default Swaps
- Applies to emission allowances
- Insider dealing covers OTC/OTFs and MTFs derivatives trading
- **Clarifies application to high frequency trading**

# Market Abuse Regulation 2016

- Provisions on commodity and related derivative markets and to ensure clarity and legal certainty
- clearly prohibits market manipulation on commodity markets using financial instruments and vice versa
- Introduces obligation on issuer to notify regulator ex post of a delay in disclosing inside information
- Grants regulators the power to permit a delay to disclosure of information of systemic importance e.g. emergency lending assistance
- Clarifies disclosure obligation for managers' transactions carried out by a portfolio manager
- Specifies more clearly the obligations on market operators to detect market abuse

# Criminal Sanctions

- Defines offences of insider dealing and market manipulation to be regarded as criminal offences by the Member States if committed intentionally
- Requires Member States to treat inciting, aiding and abetting these offences as criminal offences
- Attempts at insider dealing and market manipulation should also be criminal offences
- Criminal sanctions should be effective, proportionate and dissuasive
- Extends criminal liability to legal persons (MAD/2003 admin liability for legal persons)
- Report by Commission within 4 years on possibility of setting minimum types and levels of criminal sanctions

# MAR Provision on Sanctions

## Administrative Sanctions

- Sets out administrative offences which shall be sanctioned and the sanctions regulators shall have at their disposal
- Where profits or losses avoided can be determined, the maximum fine should be up to twice that amount
- Fixes a maximum administrative fine of not less than € 5 million, or 10% of annual turnover for a legal person
- Member States are free to set higher maximum fines
- Sets out criteria which regulators shall take into account in setting sanctions,
- Requires regulators to cooperate closely with each other and ESMA to ensure sanctions produce desired results and avoid overlaps

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# Conclusion

- Theory of insider dealing law – fiduciary duty-based (US) or misappropriation theory (EU/Swiss)
- Criminal law offence of insider dealing and market manipulation
- Civil law offence of market abuse (insider dealing and market manipulation)
- Broader offence under EU and Swiss law than US law. Related issues and case studies