Insider Trading:
Comparisons and Recent Developments

Prof. Marco Ventoruzzo

Insider Trading in the U.S.

- Sec. 10(b) 1934 SEA and Rule 10b-5
  - Broad antifraud provision, does not explicitly regulate insider trading
  - Parity of information theory (1960s: *In re Cady*; *SEC v. Texas Gulf SUlphur*)
  - Fiduciary Duty Theory: U.S. v. Chiarella (1980)
  - Rule 14e-3, 1980, no trading on info on tender offer
  - Tippees: Dirks v. SEC (1983), tippee liable if tipper breaches a FD and has a benefit and tippee knows or has reasons to know of breach and benefit
  - Misappropriation theory: U.S. v. O'Hagan (1997), misappropriating is a fraud. Mistery of FD: Chestman v. U.S., SEC Rule 10b5-2
  - Broadening misappropriation? SEC v. Dorozhko (1997)

Insider Trading in the U.S.

- Other Sec. 10(b) 1934 SEA and Rule 10b-5 issues:
  - Materiality
  - Scienter
  - Use or possession? Awarness: presumption of use, but safe harbors e.g. pre-existing plans
- Sec. 16(b)

Insider Trading in the E.U.

- MAD and MAD II and MAR
- Parity of information, very broad, with exceptions (opposite US, think of 14e-3)
- Disclosure of all price sensitive information v. U.S.?

Some Fun Cases

- Taxi driver overhears a conversation between two managers, or reads a folder forgotten on the back seat

- Analyst and Journalist: vs. their own work, vs. the publication of the report or article

Detection and Enforcement

- Stock Exchanges & Brokers – Securities Commissions – Prosecutors
- Market Survelliance and Reports of Suspicious Activity by Brokers (mandatory)
- Difficult burden of proof
- More enforcement in the U.S.? Analysis based on budgets, staff and cases (picking up also in other systems)

Culture


DECEMBER 1, 1986
$1.95
TIME
Infighting Over Iran
WALL ST. SCAM
Making Millions With Your Money
Investor "Ivan the Terrible" Boesky


HUMAN
RIGHTS
FIRST
TIME
4
TRUTH


588

Dramatis personæ

Dramatis personæ

Giancarlo Avenati Bassi

Marcello Maddalena

Dramatis personæ

Paulo Pinto de Albuquerque

Facts

loan 3 billion € expires September 2005

convertible in shares in case of default

shares had to be offered to all shareholders

Facts

March 2005 — September 2005

t

Ifil controls Fiat with over 30%

As they got closer to the repayment date, Fiat realizes that it would not be able to repay the loan

As a consequence, the banks would have obtained “lots” of shares

If the shares were offered to all shareholders, and the majority would have bought them, Ifil would have maintained control

However, the contractual price at which the shares would have had to be offered to shareholders was higher than the market price. No shares distributed among shareholders = dilution for Ifil (7%)

Facts

March 2005 — April 2005 — September 2005 — *t*

Equity Swap Contract

Basically, gives to the Fiat group the right to obtain a certain number of shares of Fiat at the expiration of the loan

This would avoid the dilution

Facts

March 2005 — April 2005 — July 2005 — September 2005 — *t*

Price of Fiat shares ↑

Possible causes:
- Merrill Lynch buys shares anticipating the possible need to perform the equity swap;
- Fiat indicated it would default, due to dilution takeovers are possible
- Good business results disclosed

Facts

March 2005 — April 2005 — July 2005 — August 2005 — September 2005 — *t*

At Consob's Request, Fiat and other corporations of the group inform the market that they cannot explain the upward price movement and that there have not been transactions on the shares in relations to the convertible loan. Ifil also discloses that it intends to remain in control of Fiat

Facts

March 2005 — April 2005 — July 2005 — August 2005 — September 2005 — *t*

September 14: Fiat sends a copy of the equity swap contract to Consob

September 20: thanks to the the equity swap the control over Fiat remains stable

A Look at the Law

Directive 2003/6/CE → Articles 184, 185, 187-bis and 187-ter T.U.F.

Market abuse

- insider trading: trading in securities while in possession of inside, price-sensitive information
- market manipulation: false or misleading statements, or other conducts, capable of affecting regular market transactions

A Look at the Law

March 2005 — April 2005 — July 2005 — August 2005 — September 2005 — *t*

Equity swap contract with physical delivery already executed, it should have been disclosed to the market! Omission affected prices.

A Look at the Law

Directive 2003/6/CE → Articles 184, 185, 187-bis and 187-ter T.U.F.

Market abuse

- insider trading: trading in securities while in possession of inside, price-sensitive information
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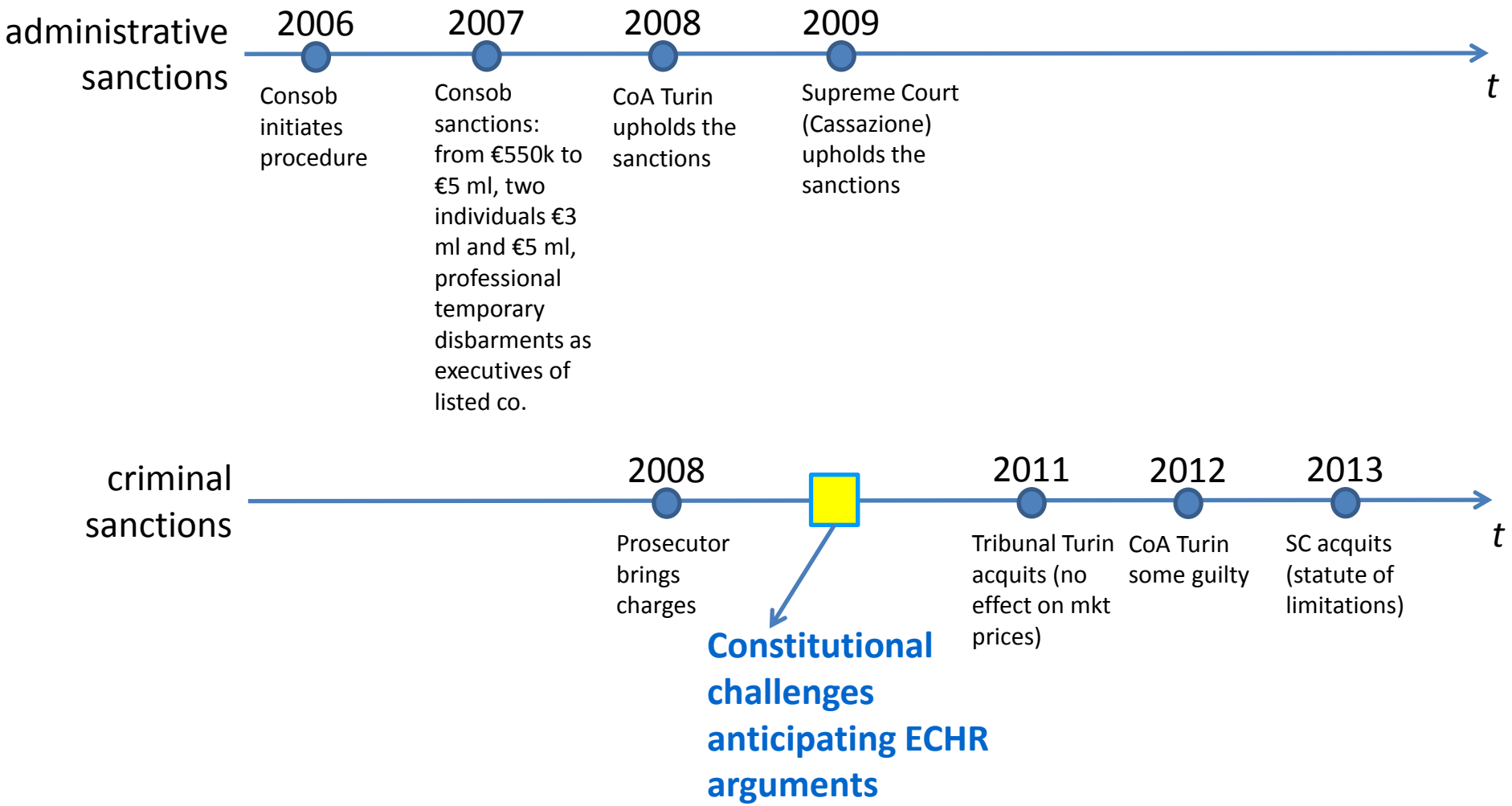
Penalties

- administrative (civil) penalties imposed by Consob (≈ SEC): fine from €200k to €5ml, plus professional suspensions
- criminal sanctions by prosecutor: jail term from 1 to 12 years, plus fines from €200k to €5ml, plus professional suspensions

Procedural History



ECHR Decision – "Criminal" Nature of "Administrative" Procedure and Sanctions

- The ECHR provides for certain protections for the accused, mainly concerning due process and double jeopardy, in criminal prosecutions (there are some protections also for "civil" penalties, but obviously they are less extensive)

- A key issue was, therefore, the criminal nature of the administrative procedure and sanctions in this case

- The ECHR applies a substantive approach, contrary to the formalistic approach followed in several European countries according to which the statutory "label" of the sanction would determine its nature

- The ECHR calls this the "labeling fraud," and determines the *de facto* criminal nature of the sanctions based on elements such as:
  - Not limited to a specific group of people (e.g. sanctions for unethical conducts of the members of the bar, administered by the bar association)
  - The "social perception" of the conduct and the punishment
  - The type and severity of the sanction: (a) Fines so high that affect liberty (sometimes also considering the economic position of the accused); (b) Occupational disbarments and similar sanctions

- ECHR precedents in antitrust (*Menarini v. Italy*, 2012); and French Supreme Court in 1996 for insider trading violations conformed to this line of cases

- "Administrative" sanctions in *Grande Stevens* are, in fact, criminal, and therefore full protection of the Convention:
  - Article 6, Due Process
  - Article 4 of Protocol 7, Double Jeopardy

ECHR Decision – Due Process

- Less interesting for us today
- Independent judge and full trial
- Basically, the internal procedure of Consob is not compliant because prosecution and decision are within the competence of the same agency, and the deciding body is the Commission itself
- This can be cured if it is possible to challenge the administrative act with a full trial
- Here criticism on the absence of a public hearing in trial (only discussion in judge's chambers); concurring opinion also stresses no complete *de novo* review in court
- Possible to cure without statutory reforms? (somehow funny consequences: in Bologna "Open the door…")
- Recent judiciary developments in Italy

ECHR Decision – Double Jeopardy

- Some weak arguments of the Italian government: e.g. reservation in the Convention (but only for statutes already enacted at ratification)
- Most interesting argument is that the relevant elements of the crime (Article 185 T.U.F.) and of the administrative sanctions (Article 187-ter T.U.F.) are not identical:
  - Actual vs. potential effect on market prices
  - Intentional vs. negligent
- The Court considers this irrelevant: the "conducts" punished are the same $\rightarrow$ violation of *ne bis in idem*

How To Avoid Due Process Violations?

- Separate more “accusers” and “judges” within financial authority, allow parties full access to documents, hearings and responses

- Make sure that there is complete judicial review after the decision with a public hearing and all the required protections

How To Avoid Double Jeopardy?

- Reduce administrative sanctions to a level that could not be considered “criminal” by the ECHR?
- Administrative if negligent, criminal if intentional?
  - “Negligent” Market Abuse is a joke
  - In any case difficult to distinguish
- Profits/damages?
  - Very difficult to measure, and also doubtful fairness
- Criminal only if actual effects on market prices and administrative is only danger?
  - Old Italian approach
  - Very difficult to determine, notwithstanding event studies
- In any case, if you create a difference, the result is a dangerous “race to the courthouse” between the SEC (Consob) and prosecutors. Who goes first? How do they coordinate?

And in the U.S.?

- Disclaimer
- Serious problem: *see* The Economist August 30th-September 5th 2014, criticizing "The Criminalization of American Business"
- Common law and constitutional (V amendment) prohibition against second prosecution for the same offence (double trial, double conviction or double punishment?)
- Several cases have affirmed that civil and criminal sanctions for the same conduct can be cumulated (e.g. suspension of driver's license), especially if remedial in nature

And in the U.S.?

- U. S. v. Halper (490 U.S. 435 (1989)):
  - Unanimous S.C. (Blackmun): violates double jeopardy; to determine if "criminal" penalty not only Congressional language & intent test, also consider if penalty not remedial, but deterrent or retribution
- Abrogated by Hudson v. U.S. (522 U.S. 93 (1997)):
  - S.C. goes back to the pre-*Halper* approach (*Walder* test), criminal/civil distinction on face of the statute and legislature's intent (in addition, *Halper* test difficult to apply)
  - Court recognizes that further analysis might establish that, notwithstanding Congressional intent to qualify a sanction as civil, its purpose or effect is so punitive to transform it in a criminal penalty, subject to double jeopardy. But the analysis should be broader than the one adopted in Halper, which focuses on the disproportion of the civil penalty with the damages suffered.
- Punitive damages?

Thank You!

marco.ventoruzzo@unibocconi.it