Commentary: European Regulators Ramp Up Insider Trading Enforcement

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On March 23, 2010, the Financial Services Authority (FSA), working with the Serious Organized Crime Agency (SOCA), arrested six men who were alleged to be involved in a sophisticated and long-running, insider dealing ring. One of those arrested was an employee of Moore Capital Management, another from Deutsche Bank, and a third was employed at BNP Paribas, all household names.

The aggressive attitude of European regulators towards insider trading, or "insider dealing," as it is called in Europe, is a relatively recent phenomenon.

Insider dealing was first made a criminal offense in the United Kingdom in 1980. During the 1980s, the Department of Trade and Industry (DTI) and the Serious Fraud Office (SFO) had the primary enforcement responsibility for insider dealing, and achieved notoriety for their successful prosecutions of four prominent English businessmen who conspired with Ivan Boesky to manipulate the stock of Guinness. After the Guinness scandal, the UK authorities reported very few enforcement proceedings until 2000, when jurisdiction over insider dealing was transferred to the FSA. But, no one spent any time in prison for insider dealing until 2009. In that year, Christopher McQuoid, an attorney and the general counsel of TTP Communications, was convicted of insider dealing and sent to prison along with father-in-law, James Melbourne, when they traded TTP shares based on McQuoid's inside information that Motorola was planning to take over the company.

Prior to 1989, the legal standard in the rest of Europe was a mixed bag. Most European nations had adopted some prohibition of insider trading, but only France imposed criminal sanctions. Enforcement was rare. In France, for example, there was only one criminal prosecution for insider dealing leading to jail time prior to 2006.

In 1989, the European Union adopted the Insider Dealing Directive, which was further amended in 2003. A Directive requires each of the European member states to adopt their own legislation to achieve the intended result. The Directive contained a definition of "insider dealing" and prescribed civil and criminal penalties, which were to be enacted on a uniform basis throughout the European Union. The Directive received applause for its clear and consistent standards. However, while the Directive required member states to place the law on their books, it did not impose any particular enforcement obligation on local authorities. In practice, there was very little evidence of its enforcement.

The ineffectiveness of the Insider Dealing Directive ultimately led to the adoption of the Market Abuse Directive in 2005. The Market Abuse Directive is a component of the Markets in Financial Instruments Directive (MiFID), which has as it goal "maximum harmonization" among the member European States. So, while the Market Abuse Directive simplified the definition of insider dealing and clarified the responsibilities of persons in receipt of insider information, its most important element commands the member states to achieve uniform enforcement of the insider dealing prohibitions. As a result, we have witnessed a rash of criminal prosecutions for insider dealing in France, Germany and the United Kingdom, the three most prominent market centers in Europe.

The relatively lax attitude of European nations to insider trading in the past reflects certain cultural attitudes. The United States, after all, has been imprisoning people for insider trading for over five decades.

Insider trading is regulated under Section 10(b) of the Securities Exchange Act of 1934, which prohibits fraudulent practices in the purchase or sale of securities. Under this legal framework, insider trading operates as a fraud on the person who buys securities from an insider. The early cases focused on the injury to people who bought securities from an insider that failed to disclose inside information to them.

But, this disclosure theory is inconsistent with our common law traditions. When it comes to the purchase and sale of things other than securities, the common law, which generally governs contractual dealings, and provides remedies for deceit, does not require a seller to disclose inside information to a buyer. The seller is not permitted to lie, and when put to the question, must tell the truth. Otherwise, the burden is on the purchaser to perform the due diligence necessary to determine that the goods will perform as hoped. So, something more than a fraud on the purchaser must explain our willingness to throw people in jail for insider trading.

Insider trading laws are intended to protect markets, rather than the lone purchaser. The purpose of markets is to establish the value of things. In turn, markets perform best when all of the information available is reflected in prices. People can still disagree about what the information means, which will result in market transactions to resolve these differences. But, when the seller of a security trades on the basis of inside information, the price of the security is incorrect. Moreover, people are reluctant to trade when it is obvious that other traders have access to important information that is not available to them.

In the United States, we have depended on markets, not only to price securities, but to allocate resources within society. The issuers of securities that are upward bound have a much easier time raising new capital than those headed for the bottom. In turn, issuers use capital to make things. If the prices of securities are wrong, too many of the wrong things, and too few of the right things, will be produced. In a society that depends on markets to perform this crucial role, which ultimately determines whether we will all be richer or poorer in future periods, market integrity becomes very important. So, the trade based on inside information doesn't just harm the purchaser, it makes all of us a little bit poorer.

In the past, European culture was more skeptical than the United States about the ability of markets to allocate resources efficiently. As a result, European nations were less willing to spend the resources necessary to regulate insider trading successfully.

The formation of the European Union reflected the recognition that the U.S. economic system had been more successful in the efficient allocation of resources. As a result, the European trend has been to emulate the United States and move in the direction of a more market-driven economy. Ultimately, the goal is "convergence," a single global capital market comprised of the European Union, the United States and Asia, uniformly regulated.

All of this suggests that last month's London arrests are only the beginning. We can expect to see many more insider dealing cases prosecuted in Europe going forward.

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