

PROBLEMS FACING IRISH INSIDER DEALING LEGISLATION AND PROPOSALS FOR AN ALTERNATIVE APPROACH

DARA O'BRIEN

Everybody of my generation was brought up to regard the city as honest and reliable and a community which always stuck rigidly to its bargain. In recent times it has become the case that you and others like you have stooped to conduct which has blemished and lowered that reputation. Your real offence is that you have breached the trust reposed in you by your clients in whose best interest you were supposed to be acting.¹

I. INTRODUCTION

The above quotation serves to outline the fundamental problem with which one is faced upon attempting to conduct an analysis of any “insider dealing” legislation. It is generally accepted in most jurisdictions that insider dealing is undesirable and, as such, needs to be subjected to some kind of regulation. This inference is usually based on two principal theories, both of which were encapsulated in a case in the United States some forty years ago. The first of these holds that confidence in the stock market needs to be maintained. The second holds that confidential information needs to be secured.²

While there can be little doubt that neither of these assumptions are per se flawed, it does not automatically follow that their natural corollary is the prohibition of all insider trading. Those who advocate deregulation in this area argue that a mere assertion that “insider trading is unfair” is both emotive and illogical.³ Hence, both legislators and judges should be mindful, lest sentiments be allowed to constitute policy reasons for legislation.

Yet the fact remains that, in a significant and ever increasing number of

¹ Ashe & Murphy, *Insider Trading* (Dublin, 1992) (quoting Farquaharson J., sentencing a former executive of Morgan Grenfell & Co. who had pleaded guilty to insider dealing).

² *Re: Cady Roberts & Co.*, 40 S.E.C. 907 (1961).

³ Ashe & Murphy, *Insider Trading* (Dublin, 1992) at p. 2.

jurisdictions, legislators have decreed that insider dealing needs an external guiding hand in order to ensure its control or prohibition. The result is an array of legislative provisions, which, because they have been enacted in the absence of any concrete policy foundations, have so far proven to be, at best, ineffective.

This paper briefly analyses the main elements of insider dealing provisions across a number of jurisdictions, focusing in particular on the contrasting approaches taken in Ireland and the U.S. with respect to 1) characterizing inside information, 2) defining “insiders” (and classes thereof) and 3) establishing and enforcing prohibitions. In so doing, the paper highlights significant problem areas in the current legislation and proffers some reasoned suggestions for a possible alternative approach to the problem which strike a balance between some of the fundamentally opposed values which, at present, are adding silt to already muddied waters.

A. Characteristics of Inside Information

In Ireland, the question of what exactly constitutes “inside information” is dealt with by Part V of the Companies Act, 1990 (which was broadly modeled on the then English legislation), section 108(2) of which states that information will achieve “insider” status if it is not “generally available but, if it were, would be likely materially to affect the price of those securities,”⁴ and if it “relates to a transaction (actual or contemplated) involving both those companies or involving one of them and securities of the other, or to the fact that any such transaction is no longer contemplated.”⁵

One of the major driving forces behind the enactment of the Irish legislation was the introduction of the European Council Directive 89/592/EEC, coordinating regulation

⁴ Companies Act, 1990, Part V, s. 108(2)(a).

⁵ *Ibid.* s. 108(2)(b)

on insider dealing and adopted on 13 November 1989. The directive does not forbid insider dealing directly, but requires member states to take action in order to conform to the common standard laid down by the Directive before its implementation date in 1992. However, the Directive only applies if the fundamental elements of insider dealing are present and certain conditions with respect to the persons restricted, the information possessed, and the securities to which the information relates are fulfilled.⁶

In order to be held liable under present Irish legislation, an “insider” must possess “inside information” as defined in section 108(2) *supra*. The concept of inside information then becomes determinable by the cumulative combination of the different parameters contained in the definition.

Although, pursuant to the European Directive, the information may *not have been made public*, in the Irish legislation, the information must not be *generally available*. This would seem to introduce a higher standard under which mere publication may not necessarily be sufficient, even in nationwide trade publications. This approach would certainly seem to be somewhat at odds with the approach adopted by other jurisdictions. For example, section 3(1)(c) of the South African Insider Trading Act 135 of 1998 (virtually a verbatim copy of the corresponding sections of the UK Criminal Justice Act 1993) holds that-

All that is required for publication is that the information is accessible to the market participants, *i.e.* Brokers, financial analysts, institutional investors and the like, regardless of actual knowledge by the public at large...⁷

The next parameter contained in the Irish definition relates to the nature of the

⁶ Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 69.

⁷ Widder, “South African Insider Trading Legislation” (2002) 23 *Company Lawyer* 191.

information itself. In the European Directive, the information must be “of a precise nature” so there will be no insider dealing if someone acts on mere rumours or speculations. Similarly, according to section 1(7) of the South African Legislation, inside information means specific or precise information.⁸ In this respect, the wording clearly resembles section 56(1) of the U.K. Criminal Justice act 1993 and it seems that in both jurisdictions:

Mere opinions, assumptions and rumours will not suffice as inside information under the act even if they are likely to have a material impact on the price of securities ... this restriction in the scope of application is necessary to avoid the offence becoming indeterminable.⁹

The Irish legislation appears to forego the precision requirement completely, leaving open the possibility that an insider who acts to deal on the basis of rumours or assumptions may still, in fact, be found liable under the legislation. This would surely seem to have potentially far-reaching impacts on securities analysts and other such market professionals who often act on the basis of such assumptions during the course of their daily business.

Overall, the Irish legislation regarding inside information seems to be consistently restrictive in its application. The Oireachtas has adopted a potentially harsher and more far-reaching position in relation to publication and the nature of the information than that required by community law and that adopted by South Africa, the UK and Singapore,¹⁰ a situation that could possibly have grave consequences for many, especially financial analysts and certain classes of journalists (who must be, no doubt, already feeling

⁸ *Ibid.* at 192.

⁹ *Ibid.*

¹⁰ Chandran, “Singapore – New Insider Trading Legislation” (2001) 22 *Company Lawyer* 63.

particularly vulnerable).¹¹

While any reform must be capable of differentiating between mere speculation and fact, the difficulty faced by anyone attempting to overhaul the law in this area is that by being too definitive, one runs the risk of unduly narrowing the scope of the legislation. A quick analysis of the U.S. law in this area will reveal that the Securities and Exchange Commission (SEC) has objected to various proposed amendments on this ground.¹²

B. Insiders (and classes thereof)

Although the possession of inside information is a necessary condition for the application of the insider dealing prohibition, it is not in itself sufficient because the legislation does not apply to the world at large, but rather to certain defined categories of persons considered as “insiders.” The current Irish legislation holds that persons who are “connected with the company”¹³ may be classed as insiders for the purposes of the legislation. It goes on to list such persons as including the following;

- (a) Officers and shareholders of the company or related companies;¹⁴
 - (b) Those occupying positions that “may reasonably be expected to give [them] access to inside information;”¹⁵
 - (c) Those occupying “any professional, business or other relationship existing between [them] (or [their] employer or a company of which [they are] an officer) and that company or a related company;”¹⁶ and
 - (d) “[Those] being [officers] of ... substantial shareholder[s] in that company or in a related company.”¹⁷
- N.B. “Officers” explicitly includes directors, shadow directors, secretaries, employees, liquidators, receivers, examiners and “any person administering a compromise or arrangement between the company and its creditors.”¹⁸

¹¹ *Re: An Enquiry Under the Company Securities (insider Dealing) Act 1985* [1988] A.C. 660.

¹² Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 50.

¹³ Companies Act, 1990, Part V, s.108(11)(c).

¹⁴ *Ibid.* s.108(11)(a) & (b).

¹⁵ *Ibid.* s.108(11)(c).

¹⁶ *Ibid.* s.108(11)(c)(i).

¹⁷ *Ibid.* s.108(11)(c)(ii).

¹⁸ *Ibid.* s.107.

Experience in the U.S., where classification of insiders based on the fiduciary duty concept, was originally used as a departure point¹⁹ has shown that such an approach did not provide adequate cover against newly emerging forms of “market abuse,” so the approach was gradually redirected so as to deal with situations involving the unfairness inherent in informational imbalances thus disregarding the fiduciary concept.²⁰ This “misappropriation approach,” based on the parties’ access to information, culminated in the *Chiarella* case²¹ which established that “regular access to information” was the appropriate test for imposing liability in insider dealing cases.²²

Despite the fact that the *Chiarella* approach was subsequently reversed by the Supreme Court (who later went on to establish a more stringent test once again requiring the existence of a fiduciary relationship between the transacting parties²³) for casting too wide a net, the current Irish legislation not only seems to have followed this approach, but actually casts an even broader net. This test does not seem to require even so much as *regular access* - an occasional or unique access could, in theory, subject persons to the insider dealing prohibition and subsequently to criminal sanctions. The prohibition, under the Irish legislation, is applicable for a period of up to six months after the relevant “connection.”²⁴ This requirement is aimed at ensuring that the information in question will have been adequately absorbed by the market. It also extends to persons “holding

¹⁹ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

²⁰ Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 12.

²¹ *U.S. v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1978). See also 588 F.2d 1358 (2d Cir. 1978).

²² *Ibid.* at 1364-1366.

²³ *Dirks v. SEC*, 681 F. 2d 824 (D.C. Cir. 1982).

²⁴ Companies Act, 1990, Part V, s.108(1).

public office.”²⁵

Prohibition, under the Irish legislation, also applies to persons who have “received the information, directly or indirectly, from another person and [are] aware, or ought reasonably to be aware, of facts or circumstances by virtue of which that other person is then himself precluded ... from dealing in those securities.”²⁶ These persons are generally known as “tippees.” The point at which one ceases to be a secondary insider and becomes a “tippee” is far from clear and can often lead to anomalous outcomes. It can also be highly problematic when insider information is extended to secondary or even tertiary tippees and even more so when inside information becomes known to a larger group of persons, especially if they happen to be securities professionals (e.g., analysts, advisors) who are already placed in a delicate position by the current legislation.

With regard to the classification of insiders, there are those who believe that the circle, especially of secondary insiders and tippees, should be limited “because a prohibition which foresees a stringent sanction, but which is ineffective because it covers an unlimited and uncontrollable number of persons would miss its essential goal.”²⁷ This argument is a lucid one, but the question remains as to whether, for example, cleaning personnel, printers, taxi drivers and others getting to know sensitive information by chance should be free to trade, while others are not, solely by virtue of their job description.

The problems arising from attempts to classify insiders manifest the need for

²⁵ *Id.* s.108(11)(c).

²⁶ *Id.* s.108(3).

²⁷ Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 86.

reform of the current Irish approach to regulating insider trading. Allegations that the area smacks of result-orientation may not be wholly unfounded. It would seem that the existing legislation is unable to set the kind of boundary necessary here, i.e., one which possesses sufficient flexibility so as to allow it adapt to the circumstances of each case in a manner which doesn't produce undue uncertainty.

C. Prohibitions and Enforcement

The basic prohibition on insider dealing in this jurisdiction is to be found in section 108 of the Companies Act 1990. The securities in respect of which insider dealing is prohibited are listed as follows:

- (a) Shares, debentures or other debt securities issued or proposed to be issued, whether in the State or abroad, and for which dealing facilities are, or are to be, provided by a recognized stock exchange;²⁸
- (b) any right, option or obligation in respect of any such shares, debentures or other debt securities referred to in paragraph (a);²⁹
- (c) any right, option or obligation in respect of any index relating to any such shares, debentures or other debt securities referred to in paragraph (a).³⁰

There are a few points which should be noted in relation to this section of the legislation. First, as MacCann observes, “the prohibition on insider dealing extends only to companies with a stock exchange quotation. It does not apply to private companies or unquoted public companies. In such circumstances the only applicable restriction would appear to be the equitable restriction imposed on fiduciaries of the company ... by reason of their fiduciary position.”³¹

Although this remedy would not seem so problematic in the case of small private companies, which the courts have been willing to treat as quasi-partnerships on occasion,

²⁸ Companies Act, 1990, Part V, s.107.

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ MacCann, “Liability for Insider Dealing – Part II” (1991) 9 *Irish Law Times* 151 at 154.

in the wake of *Percival v. Wright*,³² it would seem that a cause of action under this heading may be difficult to establish in the case of an unquoted public company. In any case, taking into consideration the fact that one of the most oft quoted arguments in favour of insider dealing regulation is the “equity argument,” the wisdom of drawing a distinction on the basis of stock market quotations is clearly questionable.

Second, under section 108(10) of the 1990 Act, a person may deal in the securities of a company if, while not otherwise taking advantage of his possession of price sensitive information relating to those securities, he complies with a number of conditions.³³ Despite the rationale behind the provision – allowing insiders (who may constantly be in possession of price sensitive information), in cases of hardship, to avoid being “locked in” to their companies for a limited period each year – it is “a somewhat unreal and metaphysical concept which will be extremely difficult to apply in practice.”³⁴ Expecting an insider to remove from his mind information of which he is aware is, at best, a bizarre proposition and one which also leaves open the possibility that he may be able to defend fraudulent transactions with some innocent excuse for dealing.

Finally, there is a further exception to the general prohibition available under the “Chinese Wall” provision of section 108(7) which allows a company to deal in “any securities at a time when any officer of that company is precluded by subsection (1), (2) or (3) from dealing in those securities” pursuant to the satisfaction of various conditions. In reality, the enforcement of this provision is equally as problematic as section 108(10) above. The likelihood of dealing actually happening as prescribed in this section is remote and, furthermore, it is easily covered up. Indeed, the “Chinese Wall” envisaged

³² [1902] 2 Ch. 421.

³³ Companies Act, 1990, Part V, s.108(10)(a), (b) & (c).

³⁴ MacCann, “Liability for Insider Dealing – Part II” (1991) 9 *Irish Law Times* 151 at 156.

by section 108(7) has proved itself to be notoriously porous in other jurisdictions.³⁵

Regarding the enforcement of the legislation, the impersonal nature of stock market trading makes it very difficult, in the absence of any causal connection between an insider trading and an investor buying, to identify persons “injured” by the dealing. When this is coupled with the grain of truth in the allegation that much insider trading is “victimless crime,”³⁶ it would appear that the sanctions available should reflect, at least in part, this uncertainty. Yet under the Irish legislation, breach of the insider trading prohibition carries the heaviest penalties of all company law legislation with a very heavy fine and/or ten years imprisonment on indictment.

Undeniably, logic dictates a heavy fine upon indictment in order to appropriately penalise the more explicative insiders, but a possible jail sentence of ten years is another matter and arguably too harsh a response to an offence, the foundations of which have still not been grounded in a rationale acceptable to many. This said, any sanctions are only as meaningful as the prosecutions which follow and, looking at the record in Ireland to date, one can hardly state with authority that the possible sanctions available under current legislation hold their *in terrorem* qualities.

The reason for the lack of enforcement is partly due to the difficulty in detection and also, arguably, partly due to the Irish regulatory mechanism. To date, there have been no successful prosecutions of insider dealing and, given recent allegations,³⁷ it would seem that there is something unsatisfactory about the existing machinery for investigation.³⁸ The lack of positive evidence that Ireland is free from “golden circles”

³⁵ Ryan, “Prohibition of Insider Trading – Tilting Windmills?” (1989) 7 *Irish Law Times* 6.

³⁶ Ryan, “Prohibition of Insider Trading – Tilting Windmills Part II?” (1989) 7 *Irish Law Times* 46.

³⁷ See *infra* note 41.

³⁸ See generally Dignam, “Report of the Company Law Review Group: Some Observations and

and the reality that the stock exchange itself is reliant on credibility may suggest that it would perhaps not be the best equipped body to enforce the legislation as it exists in its current form.

II. AN ALTERNATIVE APPROACH?

Legislative developments in both jurisdictions have moved away from viewing the concept of the “insider” as central to effective regulation, widening the scope from the traditional insider to include secondary insiders, and then again to include tertiary insiders and “tippees.” The approach adopted by the Irish legislation goes further still following the thrust of the European Directive with the result that the prohibition on insider dealing can conceivably be applied to any party privy to certain material, non-public information.

Likewise, it could be argued that the existence of major loopholes, such as those which allow for the trading in substitute stocks on the basis of inside information,³⁹ section 108(10) of the 1990 Act and the “Chinese Wall” provision of section 108(7) of the 1990 Act, when coupled with the fact that not all dealing is subject to insider dealing regulation (e.g., in *Texas Gulf Sulphur*, the fact that the owners of the land in question had not been informed of the drilling results before they sold their land was deemed to be standard business practice,⁴⁰ while less strict standards also apply to face-to-face transactions concerning moveable goods, which are subject only to common law rules of contract), represents an extension of such legislation beyond the concept of “dealing.”

With this in mind, rather than futile pursuit of the existing approaches which

Comments” (1995) 13 *Irish Law Times* 128.

³⁹ See generally Ayres & Bankman, “Substitutes for Insider Trading,” 54 *Stanford Law Review* 235 (2001).

⁴⁰ Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 181.

essentially attempt to “establish a general theory on exceptional rules whilst neglecting underlying fundamental principles,”⁴¹ a more rational approach would be to forego entirely the focus on the “insider” and the “dealing” aspects and to approach the issue on a broader basis than that implied by the term itself. If the law were instead to focus on the acquisition, use and transmission of information, as opposed to the acts of certain individuals and their relationships with others, it may find itself better equipped to resolve problematic issues.

Of course, implementing such an approach would necessarily require the recognition of property rights in information, something which is not without its complexities. As Aoki puts it, the development of intellectual property law “has now come to justify ever-increasing property rights in information itself – a result directly counter to the understanding of early English and American copyright law.”⁴² Despite this, there are sufficient guiding principles existing in other areas of law to make this a workable solution. A brief outline of the major principles that such an approach would entail follows.

If one is to accept that the law, in certain circumstances, protects the owners of information by granting them legally enforceable rights, it should then be accepted that an approach based around a business property theory should not be impossible. The major benefit of such an approach is that it would require no rules beyond agency and contract principles in order to constrain insider dealing to the degree deemed desirable by the legislature. The first problem in attempting to develop such an approach would be the initial allocation of property rights *in* information.

⁴¹ *Ibid.* at p. 199.

⁴² Aoki, “Surveying Law & Borders (Intellectual) Property & Sovereignty: Notes toward a Cultural Geography of Authorship,” 48 *Stanford Law Review* 1293 at 1299 (1996).

The initial allocation of property rights *in* information would be of prime importance because, if Coase's widely accepted theorem is applied, although interested parties will always reallocate a property right to its highest-valuing user, as transaction costs become significant, the importance of initial allocation grows due to the fact that the cost can prevent the market from shipping those rights to the most efficient position.⁴³ In dealing with the question of how such rights should be initially allocated, it should be possible to draw on the area of intellectual property law. For example, while there would be little trouble in allocating initial property rights to a single independent creator,⁴⁴ information held by firms is not self-appropriating. If information is generated by, or on behalf of, a firm, its ownership must be determined. If principles from copyright, patent and trade secrets law, albeit analogously, are applied it can be presumed that the employer, having borne the investment costs for the creation of that information, will retain the rights therein.

Provided it remains faithful to fiduciary duties, there should be no reason why the firm – via a board decision or shareholder vote – should not be free to reallocate this information to whomever it perceives to be its highest-valuing user. If this were to be a member(s) of management, it may form part of an overall compensation package in return for a lower salary(ies),⁴⁵ benefiting shareholders and thus satisfying fiduciary requirements. Such a reallocation of rights would, as in the case of reallocation between individuals, be subject to principles of contract law, fiduciary relations and agency law, rendering enforcement more certain and efficient. A requirement upon firms adopting

⁴³ See generally Coase, "The Problem of Social Cost," 3 *Journal of Law & Economics* 1 (1960).

⁴⁴ Something akin to the requirement that the information possess some "personal intellectual creativity" (See Database Dir., Art. 3(1); C.D.P.A. 1988, s.3(1)(d), 3(A)(2)) could be employed in determining whether or not information not created *ab initio* satisfies in such cases. If not, it would belong in the public realm.

⁴⁵ Carlton & Fischel, "The Regulation of Insider Trading," 35 *Stanford Law Review* 857 at 861 (1983).

such measures to make public their policy regarding the use of inside information should serve to alert potential investors, while firms not adopting such an approach could be made subject to complete disclosure or complete abstention requirements.

It must be noted that information necessarily has a dual nature and its very existence necessitates both a source and a target. In many cases, it will be desirable for a number of reasons that the target of such information should also have legally enforceable rights *to* information which will have a constraining effect on the owners rights *in* that information. Guideline principles for enforcing rights *to* information can be taken from an analysis of existing rules aimed at remedying the negative effects of outright freedom of property (e.g., constitutional restraints on exercise of property rights, consumer protection legislation and freedom of information acts addressing the problem of access to information and the corollary right to disclose). Breach of a party's right *to* information by the owner of a right *in* that information could result in civil sanction, drawing from contractual and tortious remedies for infringement of rights, or criminal sanction, drawing from trade secrets and computer crime legislation.⁴⁶

Due to their curtailing potential, these rights *to* information must be justified and because they can be imposed only by deliberate intervention, a certain amount of regulatory interference may be required. It is likely that even those who favour deregulation in the area would not be able to mount a major challenge to this interference because, generally speaking, those seeking to enforce such rights are likely to be in a much weaker position than those holding rights *in* that information. The reality of the situation, however, is that in most cases, the owner's rights will not be exclusive,

⁴⁶ Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community* (London, 1991) at p. 194.

amounting instead to “protected freedoms” which guarantee the free exercise of certain acts without excluding others from doing the same.⁴⁷

III. CONCLUSION

The preceding discussion demonstrates that the approaches adopted, both in the U.S. and in Ireland, have been proven to be, at best, ineffective. This jurisdiction has yet to see a successful conviction for insider dealing. In light of the allegations of “suspect dealings” by Biogen following the Elan announcement,⁴⁸ and DCC’s success against Fyffes, realists cannot deny that insider dealing takes place. A vast majority of the problems in this area are generated by the dual nature of information itself; what may be beneficial to one person may be harmful to another. There is a constant pull between efficiency and equity, the right to secrecy and the duty to disclose. If these binary oppositions are to be overcome, a departure from current legislative trends and an embrace of an approach focusing more succinctly on the issue of rights and allocation of information is mandated.

With regard to the degree of external intervention necessary, it would be of no real value to speculate, absent an in depth analysis of the socio-economic costs of insider dealing. It may be the case that it bears no cost to the public interest, so that regulation could be left in its entirety to the private sector. It may also turn out to be the case that the legislature decides that the primary interest to be protected is the public interest; that even licensed dealing of inside information is undesirable; and that complete and stringent external monitoring is required. The reality will probably lie somewhere in the middle. A coordinated approach of regulation by external administrative and internal

⁴⁷ *Ibid.*

⁴⁸ “SEC steps up inquiry into deals ahead of Tysabri withdrawal,” *The Irish Times*, 30 April 2005.

regulatory bodies – similar to the approach taken in the UK – is preferable. This offers a firm, yet flexible, visible administrative hand to guide the invisible hand of the market.

Without a rigorous analysis of policy considerations, it will be impossible to achieve that which should be the goal of any legal regime, namely an enforcement mechanism directly related to the degree of social harm caused. This will likely remain the case regardless of the approach chosen by the legislature. It is submitted, however, that the proposed approach would succeed in providing a greater deal of coherency than the current approach delivers.