

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(87) 111 final

Brussels, 21 May 1987

Proposal for a
COUNCIL DIRECTIVE
coordinating regulations on insider trading

(presented by the Commission)

COM(87) 111 final

PROPOSAL FOR A DIRECTIVE
COORDINATING THE REGULATIONS ON
INSIDER TRADING

Explanatory memorandum

I. INTRODUCTION

1. Securities markets have an important role to play in a modern market economy. Their main function is to make available to those involved in business activity the financial resources they require. Securities markets therefore constitute a source of finance which is essential for maintaining and, possibly, restoring the balance between companies' equity and loan capital. They therefore act as a regulating mechanism which is essential to the smooth functioning of a modern market economy. In a continually changing economy, such as that of the Community, the role of securities markets, and more particularly of secondary markets, is bound to increase, since the growth of that economy will require more and more investment.

In order to be able to carry out their role as provider of capital to the full, the secondary securities markets must ensure at all times that there is as broad a match as possible between supply and demand. The extent of that match and therefore the depth and liquidity of those markets depend, amongst other things, on the assurance given to investors that prices quoted reflect all the facts and that therefore all possible measures have been taken to

ensure equality of opportunity for all investors. In other words, the proper operation of securities markets depends on the degree of confidence they inspire in investors.

Consequently, insider trading, which enables persons with inside information to make gains at the expense of other investors, constitutes a threat to the proper operation of the securities markets, since it totally undermines equality of opportunity for investors and therefore also their confidence in those markets. If the proper operation of those markets is to be safeguarded, it is therefore essential to eliminate that threat through measures designed to prevent the use of inside information in securities transactions.

2. With a view to ensuring the proper operation of the securities markets, some Member States have introduced rules and regulations governing insider trading and others plan to do so.

At the present time four of the Member States have such rules and regulations: Denmark, France and the United Kingdom have adopted legislation penalizing the exploitation of inside information, while the Federal Republic of Germany has introduced rules under which market operators voluntarily undertake not to exploit inside information at their disposal. However, breaches of those rules are not penalized. Belgium, Ireland and the Netherlands are in the process of finalizing legislation on insider trading. In the other Member States, however, no specific rules and regulations have been introduced to deal with the problems of insider trading, except for a code of conduct drawn up by the Amsterdam Stock Exchange in the Netherlands.

This review of the situation in the various Member States thus shows that there are very marked differences between the rules and regulations on insider trading.

It would therefore seem necessary for rules and regulations to be coordinated at Community level in order to make the safeguards offered investors by the different securities markets more uniform and thus to contribute to greater interpenetration of those markets. In other words, such coordination is necessary if a genuine European securities market which is both efficient and fair is to be created. The present proposal therefore represents a step towards the setting-up of a European capital market.

3. The proposal also constitutes an essential supplement to the following Directives already adopted or being considered by the Council in the securities field:

- Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing;¹

- Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing-up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing;²

- Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing;³

- the proposal for a Directive on information to be published when major holdings in the capital of a listed company are acquired or disposed of.⁴

¹OJ No L 66, 16.3.1979.

²OJ No L 100, 17.4.1980.

³OJ No L 48, 20.2.1982.

⁴OJ No C 351, 31.12.1985.

Like the above Directives, the present proposal also aims:

- to provide effective protection for investors on securities markets;
- to ensure proper operation of securities markets throughout the Community;
- to promote, at Community level, greater interpenetration of national securities markets.

II. COMMENTARY

1. Definition of insiders

With regard to the definition of insiders, there is a choice between a narrow approach and a broader approach.

The narrow approach would have been to limit the coverage of the Directive to "primary insiders", that is to say those who by their profession or occupation are in a fiduciary relationship with or have a duty of confidentiality towards the company whose shares are in question.

It has become clear from recent cases on international securities markets that such an approach would be too limited. There is a significant risk in modern deregulated markets, particularly where financial institutions are no longer specialised, that individuals, whether acting on their own account or otherwise, could make a practice of procuring privileged information from the "primary insiders" and indeed they are or will be the main beneficiaries. Accordingly, if confidence in securities markets is to be maintained, it is also necessary to cover those persons - often described as "tippees" - who obtain such privileged information from the primary insiders and use it to their own advantage.

The Directive accordingly adopts the broader approach and covers both categories of potential insider. Articles 1 and 2 of the Directive define the prohibitions to be imposed on primary insiders, i.e. persons who, by reason of their professional position, are likely to have access to inside information. Article 3 defines the prohibitions to be imposed on secondary insiders, who obtain their inside information from persons in the first category.

2. Definition of inside information

Inside information is defined in Article 6. For information to be inside information, the following conditions must be met:

- the information must be unknown to the public, i.e. not yet published;
- it must also be of a sufficiently specific nature. A simple rumour cannot therefore be regarded as inside information;
- it must relate to one or more issuers of securities or to one or more securities ; this condition therefore covers information concerning an issuer, whether originating from within the issuer (for example, an increase in profits) or outside it (for example, a bid to take it over launched by another company). It also covers information on the situation or prospects of one or more securities and information which is likely to influence the market as such (for example, the decision of a central bank to alter the discount rate);
- the fourth and final condition is that the information must be likely to have a material effect on the price of the security or securities in question. All information unknown to the public is not therefore necessarily inside information. If such were the case, the managers or directors or even most of the employees of a company would never be able to carry out transactions in the securities of their companies, since they always have information which has not been published.

3. Prohibitions imposed on insiders

The prohibitions which the Directive imposes on insiders are set out in Articles 1 to 3 of the Directive.

- (a) First, the primary insiders defined in Article 1, who acquire inside information in the exercise of their profession or duties must be prohibited from taking advantage of such information to buy or sell, either directly or through the medium of another person, securities admitted to trading on the stock exchange market.

This prohibition therefore applies where:

- the insider has acquired inside information in the exercise of his profession or duties;
 - the insider carries out a transaction in a security admitted to trading on the stock exchange market, whether on the official market or on a parallel stock market such as the "Second Marché" in France or the Unlisted Securities Market in the United Kingdom. It should be noted that the transaction need not necessarily be carried out on the stock exchange market itself. Off-market transactions are also covered if they are carried out through a professional intermediary such as a bank, stockbroker or dealer;
 - the insider takes advantage of the inside information, i.e. if his decision to buy or sell securities has been taken in the light of that information. If a transaction is not triggered by inside information, therefore, it is not covered by the prohibition.
- (b) Second, the insiders defined in Article 1 must also be prohibited from disclosing inside information at their disposal. Insiders should not therefore be able to communicate such information to a third party unless it is necessary or appropriate for them to do so in the normal course of exercising their profession or duties.
- (c) Third, a ban must be imposed on what is commonly called "tipping". Insiders in possession of inside information may not use such information to recommend a third party to buy or sell securities admitted to trading on the stock exchange market.
- (d) The secondary insiders, defined in Article 3, are similarly prohibited either from knowingly taking advantage of inside information disclosed to them by primary insiders to buy or sell, either directly or indirectly, securities admitted to trading on the stock exchange market. They are further prohibited from disclosing such information to third parties or from using that information to recommend a third party to buy or sell securities.

4. The rules governing territorial application

Articles 1 and 2 of the proposal for a Directive determine which Member State is competent to act in the event of insider trading. The rules on territorial application in those Articles are as follows:

- Article 1 stipulates that, in the event of a purchase or sale of securities by an insider, the competent Member State is that on whose territory the purchase or sale took place. Where such a purchase or sale is carried out on the stock exchange market, the competent Member State is clearly that in which the stock exchange in question is located or operates. Territorial application is a much more complex matter where a purchase or sale is carried out outside the stock exchange market, since there is no real link with a given country. The transaction can be regarded as having been carried out on the territory of the Member State in which the insider is resident; however, it can also be regarded as having been carried out on the territory of the Member State in which the other party to the transaction is resident. This second criterion has been adopted for the purpose of the proposed Directive because the other party to a transaction carried out by an insider is a victim of that insider, and it is the victim that must be protected (by giving jurisdiction where necessary to the courts of the Member State in which that victim is resident).
- The question of competence in the case of breaches of the two other bans laid down in Article 2 does not raise any problems. If an insider communicates inside information to a third party or if he recommends a third party, on the basis of such information, to buy or sell securities, the Member State in which the insider is resident is clearly competent since the offence has been committed by that insider.

5. Publication of inside information

Prompt publication of inside information is the best means of preventing insider trading, since it reduces to a minimum the period during which such information is inside information because it is known only to a small number of persons.

The proposed Directive accordingly contains a provision (Article 7) which requires companies whose securities are admitted to trading on the stock exchange market to inform the public immediately of any circumstance or decision which would be likely to influence the price of those securities.

However, if such information cannot be published immediately since it would harm the legitimate interests of the company, that company must immediately inform the competent authorities, who may relieve it of the obligation to publish it immediately.

The Directive of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing already imposes on listed companies an obligation to provide such information.

Point 5(a) of Schedule C annexed to that Directive stipulates that:

"The company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares.

The competent authorities may, however, exempt the company from this requirement, if the disclosure of particular information is such as to prejudice the legitimate interests of the company."

However, this provision of the Directive on the conditions for the admission of securities to stock exchange listing applies only to issuers of securities officially listed on a stock exchange. For the purpose of the present legislation, therefore, it must be supplemented by a similar but wider provision which also covers issuers whose securities are admitted to trading on a market other than the official one, for example the "Second Marché" in France, the "Mercato Ristretto" in Italy or the Unlisted Securities Market in the United Kingdom.

6. Monitoring of the application of the provisions of the proposed Directive

It is essential that supervisory authorities be designated to monitor application of all rules and regulations designed to combat insider trading effectively. Without such authorities, it would not be possible to detect insider trading and in particular to identify those responsible.

This is why the proposal for a Directive stipulates that each Member State must designate the authority or authorities competent to oversee application of the provisions of the proposal. In order to be able to carry out that task

with maximum efficiency, those authorities should be given all the powers necessary for the exercise of their duties. Thus, they should have sufficiently wide investigative powers to be able to ascertain from financial intermediaries their clients' true identities.

Also with a view to ensuring the proper application of the provisions of the proposed Directive, the proposal introduces the principle of cooperation between the competent authorities in the various Member States. As the competence of the national authorities and, in particular, their investigative powers are limited territorially, such cooperation may be essential for tracing a string of transactions and identifying, in the event of cross-frontier transactions, the insiders ultimately responsible.

Cooperation between supervisory authorities should normally take the form of information exchanges. The proposal for a Directive therefore provides for the authorities in the Member States to exchange any information required for carrying out their duties. In order to ensure that information communicated in this way remains confidential, provision has been made for it to be covered by the obligation of professional secrecy.

Provision has also been made for the responsibilities of the Contact Committee set up by the Directive coordinating the conditions for the admission of securities to official stock exchange listing to be extended to include the field covered by the present proposal for a Directive. The Contact Committee will have the task of facilitating the harmonized implementation of the Directive's provisions through the exchange of views. It will also be responsible for advising the Commission, if necessary, on any additions or amendments to the Directive. Finally, by providing a forum for regular contacts between the authorities in the different Member States this Committee should also promote effective cooperation between those authorities, which should help in combating insider trading.

Proposal for a Council Directive coordinating regulations on insider trading

COM(87) 111 final

(Submitted by the Commission to the Council on 25 May 1987)

(87/C 153/09)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 54 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas Article 54 (3) (g) provides that the Council shall coordinate to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community;

Whereas the secondary market in transferable securities plays an important role in the financing of undertakings;

Whereas, for it to be able to play that role effectively, every possible measure should be taken to ensure that that market operates smoothly;

Whereas the smooth operation of the secondary market depends to a large extent on the confidence it inspires in investors;

Whereas one of the factors on which such confidence depends is the assurances afforded to investors that they are placed on an equal footing;

Whereas insider trading, by benefiting certain investors at the expense of others, is likely to undermine that confidence and may therefore prejudice the smooth operation of the secondary market in transferable securities;

Whereas it is therefore necessary to take all appropriate measures to combat insider trading;

Whereas in most Member States there are no rules or regulations prohibiting insider trading; whereas the rules or regulations that do exist differ appreciably between Member States;

Whereas it is therefore necessary to adopt coordinated Community rules in this field;

Whereas such coordinated rules also have the advantage of helping, through cooperation between the competent authorities, to combat transfrontier insider trading more effectively,

HAS ADOPTED THIS DIRECTIVE:

Article 1

1. Member States shall prohibit any person who, in the exercise of his profession or duties, acquires inside information as defined in Article 6 from taking advantage of that information to buy or sell on their territory, either directly or through another person, transferable securities admitted to trading on their stock exchange markets.

Where the purchase or sale of transferable securities is carried out on a stock exchange market, it shall be deemed to be carried out on the territory of the Member State in which the stock exchange in question is situated or operates.

Where the purchase or sale of transferable securities is carried out outside a stock exchange market, it shall be deemed to be carried out on the territory of the Member State in which the counterpart of the person referred to in the first subparagraph is resident.

2. The prohibition laid down in paragraph 1 shall not apply to transferable securities bought or sold outside a stock exchange market without the involvement of a professional intermediary.

Article 2

Member States shall prohibit any person who is resident on their territory and who acquires inside information in the exercise of his profession or duties from:

- disclosing that inside information to a third party unless such disclosure is made in the normal course of exercising his profession or duties,
- using that inside information to recommend a third party to buy or sell transferable securities admitted to trading on their stock exchange markets.

Article 3

1. Member States shall impose the prohibition provided for in Article 1 in accordance with the terms referred to therein also on any person who has knowingly obtained inside information from a person who has acquired that information in the exercise of his profession or duties.

2. Member States shall prohibit any person referred to in paragraph 1:

- from disclosing the inside information to a third party,
- from using that inside information to recommend a third party to buy or sell transferable securities admitted to trading on their stock exchange markets.

Article 4

Member States may lay down more stringent rules than those contained in this Directive provided that they are non-discriminatory.

Article 5

For the purposes of this Directive transferable securities shall include not only securities usually traded on the stock exchange market such as shares and debt securities but also traded options relating to such securities.

Article 6

For the purposes of this Directive, inside information is information unknown to the public of a specific nature and relating to one or more issuers of transferable securities, or to one or more transferable securities, which, if it were published, would be likely to have a material effect on the price of the transferable security of transferable securities in question.

Article 7

1. Issuers whose transferable securities are admitted to official listing in one or more Member States or are traded there on another stock exchange market shall immediately inform the public in that Member State or those Member States of any circumstance or decision which would be likely to have a material effect on the price of such transferable securities.

2. Where an issuer is unable to inform the public immediately of a circumstance or decision as referred to in paragraph 1 because disclosure would prejudice its legitimate interests, it shall immediately inform the competent authorities thereof, who may relieve it of the obligation provided for in paragraph 1.

Article 8

1. Member States shall designate the authority or authorities competent to ensure that the provisions adopted pursuant to this Directive are applied. They shall inform the Commission accordingly, indicating, if appropriate, how duties have been allocated.

2. The competent authorities shall be given all such supervisory powers as may be necessary for the exercise of their duties.

3. The competent authorities in the Member States shall cooperate wherever necessary for the purpose of carrying out their duties and shall exchange any information required for that purpose.

Article 9

1. Member States shall provide that all persons employed or formerly employed by the competent authorities referred to in Article 8 shall be bound by professional secrecy. Information covered by professional secrecy may not be divulged to any person or authority except by virtue of provisions laid down by law.

2. Paragraph 1 shall not, however, preclude exchanges of information between the various Member States by the authorities referred to in Article 8 as provided for in this Directive. Information thus exchanged shall be covered by the obligation of professional secrecy to which the persons employed or formerly employed by the competent authorities receiving the information are subject.

3. Without prejudice to cases falling under criminal law, the authorities referred to in Article 8 which receive information may use it only for the exercise of their duties and in connection with administrative or judicial proceedings specifically relating to the exercise of those duties.

Article 10

The Contact Committee set up by Article 20 of Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing ⁽¹⁾ shall also have as its function:

- (a) to facilitate the harmonized implementation of this Directive through regular consultations on any practical problems which arise from its application and on which exchanges of view are deemed useful;

⁽¹⁾ OJ No L 66, 16. 3. 1979, p. 21.

- (b) to advise the Commission on any amendments to be made to this Directive.

Article 11

Member States shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive.

Article 12

1. Member States shall take the measures necessary to comply with this Directive not later than 31 December 1990. They shall forthwith inform the Commission thereof.

2. Member States shall communicate to the Commission the provisions of national law which they adopt in the field governed by this Directive.

Article 13

This Directive is addressed to the Member States.