AMERICAN AND GERMAN REGULATION OF INSIDER TRADING: A COMPARISON

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It is extremely important for American business people to be aware of approaches to regulation of insider trading within the European Union, particularly the approach of Germany, its single most influential member. At the same time, European Union members must be sensitive to the completely different approach to prohibited insider trading which is used by American courts. Failure of business people on either side of the Atlantic to be alert to significant differences between the two trading partners could result in criminal prosecution for actions which are perfectly legitimate in the investor's own country. Moreover, such inconsistencies can create opportunities for market failure. Given the significant and increased commercial relationship between the United States and the European Union, particularly Germany, the problem will only be exacerbated as global investment escalates.

This paper considers the differing approaches taken by the United States and Germany to regulate insider trading. It also compares and contrasts the American securities law with its German counterpart, as well as the differing tax consequences of the American and German regulation of insider trading.

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We are living in an age of increasing internationalization and interdependence of world markets. The most significant trading entity for the United States is the European Union (EU). Within the EU, the most influential player is Germany. This paper addresses a specific aspect of America's crucial commercial relationship with Germany: i.e., the differing approaches taken by each country in attempting to regulate insider trading.

"Insider trading" generally refers to the improper use of material nonpublic information by persons in a position of influence in publicly traded companies. The American approach rejects a definition of what activity is prohibited and who would be considered an insider and instead relies on case law to establish culpability. The Germans, on the other hand, in 1994 passed a law which strictly defines prohibited insider trading, including who would be considered an insider.

Although Germany is still reluctant to become a dominant influence in international military policy (Dale, 1994-95a), in the economic sphere it has exerted major influence, particularly in urging the political and economic integration of the former Soviet bloc with the EU (Dale, 1994-94b). At the same time, the differences between the German and American systems continue to become increasingly more important because they create more opportunities for market failure.

A short synopsis will indicate how significant Germany and the United States are to each other's economies. In 1992 Germany was the United States's fourth largest trading partner, after Canada, Japan and Mexico ("German-American," 1993). American businesses have played an important role in the business development associated with the privatization of former East German state holdings ("German-American," 1993). However, total American direct investment in Germany declined from 40 percent in 1984 to 30 percent in 1990 as a percentage of total foreign direct investment ("German-American," 1993).

Recently there was a very serious challenge to the EU by a German attorney and politician named Manfred Brunner, who argued that the Maastricht Treaty - the master plan for the EU - would deprive German citizens of fundamental rights guaranteed by the German constitution (Gumbel, 1993). So far, however, such challenge has been unsuccessful.

The past two years have seen an acceleration of enthusiasm for the EU. Three new countries in popular elections have agreed to join the EU: Sweden, Austria, and Finland. Swedish voters strongly approved the government's recommendation to join the EU despite concern from a vocal opposition that membership in the EU would compromise Sweden's commitment to political neutrality, human equality and environmental protection (Miller, 1994). Ironically, it had been thought that a strong vote by Sweden for EU membership would

positively influence the Norwegian vote, which followed two weeks later ("Sweden EU," 1994). In fact, however, Norway rejected membership by a vote of 53 percent against and 47 percent for on November 28, 1994. That margin was also almost identical to a similar poll in 1972 ("Norwegians Vote," 1994). The Norwegian vote was also a surprise because Finland had voted on October 16, 1994 by a vote of 57 percent to 43 percent to join the EU. However, of the three scandinavian votes, Finland had been regarded as the most certain to approve joining the EU (Goldsmith, 1994).

Thus, as of January, 1995, a new phase in the process of European unification began, representing fifteen countries, eleven official languages, and 370 million people ("Neuer Abschnitt," 1995). EU officials are extremely optimistic regarding recent industrial rebounds and rise in consumer spending (Roth, 1994). Economists projected that domestic EU demand would rise by 2 percent in 1994 after a 1.8 percent contraction in 1993, with accelerated growth rates of 2.8 percent in 1995 and 3.1 percent in 1996 (Roth, 1994). Certain economies, such as Denmark, Spain, France and Ireland could advance by more than 3 percent in 1995 (Roth, 1994). Industrial spending on new equipment is expected to be better than 7 percent in 1995 in Germany, Belgium, France, Ireland, Italy and the Netherlands (Roth, 1994). Throughout Europe consumers are expected to manifest their confidence in the European economies by increased spending (Roth, 1994).

AMERICAN LAW

In this increasingly global and interdependent environment, business people on both sides of the Atlantic are going to be faced with securities regulation by countries other than their own. This paper addresses the differing approaches to securities regulation of American and German law, which represent totally opposite approaches to the regulation of insider trading. This situation may promote insecurity in those dealing with international securities markets, while at the same time may allow some fraud to escape detection. For example, in March, 1995 charges of insider trading were filed by the Security and Exchange Commission (SEC) against six men for allegedly being involved in illicit trading in shares of Norton Co. and Motel 6 L.P. (McMorris & Welsh, 1995). Two German nationals were implicated in the scheme which yielded alleged profits of at least $5.6 million for the six defendants and others whom they tipped off (McMorris & Welsh, 1995).

The American approach to regulating insider trading has been to rely on a case-by-case basis to define what is prohibited insider trading. This approach has generated considerable controversy, because persons are being prosecuted for a crime that is undefined by statute. Yet constitutional due process considerations require notice of potentially criminal action before penalties can be imposed. The opposing view, which to this point has prevailed in Congress,

is that to define prohibited insider trading would allow clever attorneys to discover loopholes in the definition. A Wall Street Journal article from eight years ago discusses these contradictory positions and remains completely valid today (Ingersoll, 1987).

Although legal analysts will dispute which of the cases decided by the U. S. Supreme Court are of most significance in determining liability for insider trading, this paper focuses on three significant cases. In each one of these cases the high court focused on a different aspect of what activity would be deemed in violation of Section 10b of the 1934 Securities Exchange Act (1934 Act) and SEC Rule 10b-5 promulgated thereunder.

Chiarella v. U.S. (1980) involved alleged wrongful insider trading by the defendant Chiarella, who worked for a financial printing company in New York City. Although the financial documents, which were printed at the company, had the names of the corporations masked, Chiarella was able to figure out from other data in the documents what companies were involved in hostile takeovers. Because Chiarella's actions took place in the environment of merger mania of the late 1970's and early 1980's, there was considerable opportunity for investors to make large sums of money based on trading on material information regarding such activity which was not available to the public at large. When it was discovered by the SEC that Chiarella had traded successfully based on information he obtained from the financial documents he was printing, action was initiated against him for wrongful use of material nonpublic information.

The question of Chiarella's liability ultimately was addressed by the U.S. Supreme Court, which held that the mere possession of material nonpublic information does not result in a duty to disclose or refrain from trading. Rather there must be the existence of some sort of fiduciary relationship and hence consequent duty between the person engaging in such trading and the corporation whose shares are being traded. Chiarella had no relationship whatsoever to any of the companies whose shares he traded and consequently did not breach any fiduciary duty to them. Thus, this case established that for purposes of liability under American securities laws a fiduciary duty must be breached before any wrongdoing can be established.

The second seminal case decided by the U.S. Supreme Court in defining prohibited insider trading involved Raymond Dirks, a securities analyst in New York City (*Dirks v. SEC*, 1983). Dirks did not involve himself in any trading at all. Rather the question of his liability arose out of the information he discovered when he investigated Equity Funding Corporation pursuant to a request from a former officer of the company named Secrist who was concerned regarding actions by top corporate management which Secrist believed jeopardized the very existence of Equity Funding Corporation. Dirks flew to Los Angeles and spoke to a wide variety of Equity Funding employees. Although top management denied that there were any problems, lower level employees said that the company was in serious trouble. Dirks tried to get the *Wall Street*

Journal to report his findings, but it refused, fearing a defamation suit. When he returned to New York, Dirks advised his clients, many of whom were institutional investors with millions of dollars in Equity Funding, to sell their shares. Shortly afterwards, the information regarding the precarious financial condition of the company became public and trading of its shares on the New York Stock Exchange was halted. Many investors lost millions of dollars in the debacle.

When the high court reviewed the question of Dirks' possible liability under Section 10b and Rule 10b-5, it primarily focused on his status as a "tippee" and the possible liability of such a tippee under the securities laws. This question was resolved based on the motivation of the "tipper" (the corporate insider with a Chiarella type obligation) in transferring material nonpublic information to a tippee (an outsider with no relationship to the corporation, such as Dirks). Because Secrist, the insider/tipper, only wished to expose wrongdoing by the corporation, he did not have an improper motivation when he shared material nonpublic information with Dirks. As a tippee Dirks inherited Secrist's motivation which was not improper. Absent improper motivation by the tipper, there can be no derivative liability to the tippee.

This case also introduced the concept of a constructive or temporary insider, to whom material nonpublic information is entrusted by corporate insiders in order for the corporate or temporary insider to perform services for the corporation. Examples would include attorneys and accountants being entrusted with secret corporate information in the course of rendering professional services. Such persons have all the fiduciary obligations of a traditional insider regarding the information they have received.

The final important case in which the U.S. Supreme Court addressed the parameters of insider trading involved someone who was not in a corporate capacity at all, but rather was a reporter for the *Wall Street Journal.* R. Foster Winans had the byline for the popular column in the newspaper called "Heard on the Street". His column was so successful that his predictions became self-fulfilling prophecies: i.e., if he predicted that a stock would do well, demand for the stock would result, and the stock's value would increase. Winans saw the opportunity to make profits for himself and entered into a conspiracy (along with his roommate, Carpenter)whereby he would sell the information to appear in the column prior to its publication. When the conspiracy was discovered, Winans and Carpenter were prosecuted for illicit insider trading (*U.S. v. Carpenter*, 1987). Although many commentators predicted that Winans would be acquitted because he had no fiduciary duty under the *Chiarella* standard nor tippee or constructive insider under the Dirks standard, the high court found him liable under a theory of misappropriation. By using for personal gain information which belonged to his employer, the *Wall Street Journal*, Winans misappropriated information.

GERMAN LAW

In sharp contrast to the United States, until recently insider trading in Germany was perfectly legal. However, there was a major change in the German approach when a new law became effective on August 1, 1994 following a 1989 Directive by the Commission of the European Community (Ascarelli, 1989). (Note that the term European Community (EC) was replaced by the term European Union (EU), connoting a closer relationship among the member countries). This law represents a major change in the German law, because it is the first time that prohibited insider trading has been defined with specificity.

Just as in the United States, there were high visibility cases involving controversial insider trading on the German stock exchange. Indeed, there was a high visibility case way back at the turn of the century in 1904 where the Reichsgericht decided a case in which someone sold mining shares fifteen minutes after he had read in the newspaper about an accident in the mine (*Jüristishe*, 1904). Perhaps the most important case, and the one which probably most directly led to the enactment of the new law, involved Franz Steinkühler, who was the chairman of one of Germany's most powerful trade unions ("German Union," 1993). The scandal involving Steinkühler was a classic situation whereby he made a huge profit based on information he had obtained while sitting on Daimler-Benz AG's supervisory board (equivalent to an American board of directors) ("German Union," 1993).

Unlike in America, in Germany it is common practice for top union officials to sit on boards of directors of companies where their unions are strongly represented. Steinkühler bought a large number of Mercedes AG Holding shares shortly before the holding company's shares were converted into higher priced Daimler-Benz on a one-for-one basis ("German Union," 1993). At that time insider trading was not illegal in Germany, but it was certainly frowned upon ("German Union," 1993). The situation involving Steinkühler was especially controversial, because he was very influential and well-beloved by union members. In particular he could not explain why he had bought the shares not in his own name, but in the name of his small son. That was especially suspicious (Boss & Alsheimer-Barthel, 1993).

The most significant milestone on the way to a statutory definition of prohibited insider trading in Germany was the Directive submitted by the EC. The EC Commission worked until May, 1987 on a first proposal (*Amtsblatt*, 1987). A second proposal followed in October of 1988 (*Amtsblatt*, 1988). The Directive itself was submitted on November 13, 1989 (*Amtsblatt*, 1989) and the EC member states were to comply by amending their laws by June 1, 1992 (George, Boss & Haraldson, 1992). The German government did not manage to comply in time, because the intention was to have the Insider Law become part of a larger framework of regulation, which included the goal of modernizing the German financial center (Finanzplatz Deutschland) (Assmann, 1994a). The Directive was prepared in response to the fact that each

member state of the EU regulated insider trading differently (Assmann, 1994a). These approaches varied from utilizing a voluntary code of conduct to imposition of criminal penalties to an absence of any regulations at all (Assmann, 1994a). As previously noted, Germany had relied on voluntary self regulation to deter insider trading (Assmann, 1994a).

The new German law (Finanzmarktforderüngsgesetz) prohibiting insider trading initiated a "new age" whereby Germany will become internationally more competitive for investors, according to German Finance Minister, Theo Waigel (o.v.: 5 Jahre Haft, 1994). In reality the new law is actually a blended law incorporating laws for bond and share trading and laws for the amendment of bond and stock regulations (börsenrechtlicher und wertpapierrechtlicher Vorschriften). One of its most important features is a new federal supervising office for bond trading (Bundesaufsichtsamt für den Wertpapierhandel). This office performs different functions, but investigating and fighting insider trading is its most important function. Therefore, the office is given a wide variety of tools to explore the activities of issuers, banks, brokers, and others involved in the stock exchange (alle Marktteilnehmer). The "Marktteilnehmer" has to inform the supervising office within one day about all transactions in shares traded on the stock exchange. The office can request details about such transactions, including customer names. Moreover, personnel from the supervising office are allowed to visit the offices of the "Marktteilnehmer" and require proof of transactions. If its suspicions are aroused, the supervising office must inform the state prosecutor (Wittich, 1995a).

The "Bundesaufsichtsamt" observes all unusual price movements and unusual/large share transactions with a specially designed computer program called Stock-Watch. This program also provides information about the date, time, quantity, and price of sales and purchases as well as the names of the banks and stock brokers involved (Wittich, 1995b).

From now on it will be forbidden to gain profit from the use of confidential information which might influence the price of shares on the German stock exchange (for example, an approaching merger). Offenders may be prosecuted and face up to five years imprisonment.

Completely contrary to the American approach, the new law contains a very broad definition of insiders. Clearly directors, members of the board or major shareholders, or those who by their activity (stockbroker, director's secretary, accountant, Betriebsrat) have knowledge of information which is not yet published and which can influence share prices would be considered insiders (Boss & Alsheimer-Barthel, 1994). Even the taxi driver, the flight attendant and the cleaning lady who obtained any information in due course of their profession are insiders. It is also clear that it is not forbidden to exploit information which was obtained through observation and analysis of the economy and the stock exchange based on publicly known information. However, the German Securities Trading Act does not provide an answer as to what is to be included in "publicly known" information (Kümpel, 1994b).

Responsibility for the new law will be assumed primarily by the major German banks and to a lesser extent by other public companies. This assignment is based on the fact that German banks have many opportunities to come in contact with inside information (Assmann, 1994b). The banks are required to install a compliance officer, who although remaining a bank employee will function as a state prosecutor (Boss & Alsheimer-Barthel, 1994). The compliance officer will match two types of information: material events which create insider knowledge and complete documentation of all security transactions by bank employees, particularly highly placed employees (Boss & Alsheimer-Barthel, 1994). The compliance officer will communicate directly with the newly established federal supervisory office to report all findings (Boss & Alsheimer-Barthel, 1994).

Under the new law a public limited company must inform the "Bundesaufsichtsamt für den Wertpapierhandel" immediately about any facts about itself as well as other companies in which it has more than a 5 percent interest (Beteiligungen), which would considerably influence share prices. Then the Bundesaufschtsamt will decide if these facts must be published or not. If the facts must be published, then the information is disseminated immediately by creating the "Bereichsöffentlichkeit" (Jürgens, 1995).

The new federal supervisory office became operational at the beginning of 1995 at the German stock exchange in Frankfurt. It will be supported by state control offices (Börsenaufsichtsbehorde der Lander) and by a trade control center (Handelsuberwachungs-stelle) at each of the eight German stock exchanges located in Frankfurt, Düsseldorf, München, Hamburg, Stuttgart, Berlin, Hannover, and Bremen (Kümpel, 1994a). It is expected that this new structure will strengthen confidence in the reliability and fairness of the German stock exchange.

TAX LAW

The tax treatment is important to the regulation of insider trading in that the amount of penalty, if any, is affected by the tax consequences of the "return of profits." If the insider obtains some type of tax benefit (i.e., deduction, credit, etc.) for the "return of profits," then there is essentially no or very little ramification for engaging in this prohibited activity. Thus, the insider or wrongdoer is restored to the status quo before any wrongdoing had occurred. On the other hand, if the insider obtains no tax benefit for the "return of profits," then he is essentially penalized in the amount of the tax paid when the prohibited activity took place and the initial profits were made. The Americans take the former approach. Since the Germans do not require the "return of profits," the tax benefit issue is not addressed unless an insider voluntarily "returns the profits." However, both countries agree that any fines and/or penalties are not deductible.

Under the SEC rules, persons who engage in prohibited insider trading are required to return the profits generated from violation of the securities laws. This "return of profits" is normally called disgorgement. It is one of the most common forms of ancillary relief granted in SEC enforcement actions and has been ordered in a wide variety of cases (*SEC v. Drexel Burnham Lambert Inc.*, 1993; *SEC v. Texas Gulf Sulphur Co.*, 1971). As such, the Court in *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb, Inc.* (1990) found no meaningful distinction between disgorgement in insider trading cases under Section 10(b)-manipulative or deceptive devices versus Section 16(b)-short swing profits of the 1934 Act. Under both sections, disgorgement is a proper measure of damages which serves the equitable purpose of depriving a wrongdoer of ill-gotten gains. Moreover, Section 10(b), like Section 16(b) is a remedial provision (*Litton v. Lehman*, 1990).

The amount of disgorgement should be a reasonable approximation of profits causally connected to the violation, that is, all profits gained while in violation of the securities law (*SEC v. Drexel Burnham Lambert Inc.*, 1993). The traditional measure of actual damages is the out-of-pocket loss measured by the difference between the fair value of what the injured party received and the fair value of what the injured party would have received had there been no fraudulent conduct (*Litton v. Lehman*, 1990). However, if the wrongdoer's profits are greater than the injured party's actual loss, the proper measure of damages will be the amount of the wrongdoer's profits (*Litton v. Lehman*, 1990). Thus, disgorgement is limited to compensatory, non-speculative damages and as such, the computation of actual damages does not include consideration of predicted or anticipated tax benefits (*Torres v. Borzelleca*, 1986). However, if the injured party received actual tax benefits as a result of the fraudulent transactions, the actual damage award must be reduced by the value
of that tax benefit (*Austin v. Loftsgaarden*, 1982).

The purpose of disgorgement is to prevent unjust enrichment by depriving a wrongdoer of ill-gotten gains. As such, it merely returns the wrongdoer to the status quo before any wrongdoing had occurred (*SEC v. Lorin*, 1994). However, fines, penalties, and forfeitures alter the status quo before any wrongdoing took place (*SEC v. Lorin*, 1994). Thus, by definition disgorgement is remedial and not punitive (*SEC v. Lorin*, 1994; *SEC v. Blatt*, 1978). Many years earlier, 1915 to be exact, the Supreme Court in *Meeker v. Lehigh Valley Railroad Co.* (1915) concluded that disgorgement does not constitute a fine, penalty, or forfeiture by explaining that "strictly remedial" liabilities do not fall under the "catch-all" statute because they are not "punitive". As a result, subsequent courts have held that a wrongdoer will not be subject to liability to both the SEC and private parties because such liability would be clearly punitive in its effect and would constitute an impermissible penalty assessment (*SEC v. Lorin*, 1994; *Litton v. Lehman*, 1990).

Whether disgorgement is characterized as a tax deduction depends on the facts and circumstances of each case. Most of the tax cases deal with Section 16(b) of the 1934 Act. However, based on the fact that disgorgement has the same definition in tax cases dealing with Section 10(b), any outcome of Section 16(b) tax cases can be analogized to Section 10(b) tax cases.

Early cases in this area were in disagreement as to deductibility. In 1951 the U.S. Tax Court, in the *Davis, Jr. v. Commissioner* (1951) case concluded that disgorgement in a Section 16(b) case was a penalty and a deduction was disallowed since it would mitigate the deterrent effect of the statute and subvert a sharply defined public policy. The sharply defined public policy was the fact that Congress considered transactions in violation of Section 16(b) to be detrimental to the public welfare and designated disgorgement of profits as a substantial deterrent to insider trading violations. Later the U.S. Tax Court, in the *Marks v. Commissioner* (1956) case concluded that disgorgement of insider profits under Section 16(b) was deductible as an ordinary business expense since the disgorgement was made to protect business reputation and not to frustrate a sharply defined public policy. In light of these two cases the Internal Revenue Service (IRS) issued *Revenue Ruling* 61-115 (1961) stating that a deduction for disgorgement of profits will not be denied on the grounds that it frustrates sharply defined public policy and whether it is deductible as an ordinary loss or a capital loss depends on the nature of the profits.

If the profit was ordinary income, then the disgorgement will give rise to a fully deductible loss (*Pike v. Commissioner*, 1965). If the profit was capital in nature, then the disgorgement will give rise to a capital loss deduction (*Mitchell v. Commissioner*, 1970; *Anderson v. Commissioner*, 1973; *Cummings v. Commissioner*, 1974; *Brown v. Commissioner*, 1976). These cases dealt with Section 16(b) of the 1934 Act. However, the U.S. Tax Court in *Bradford v. Commissioner* (1978), a Section 10(b) tax case, took a different approach using the origin-of-the-claim test and stated that the disgorgement of profits related to an acquisition of a capital asset were capital expenditures to be added to the basis of the stock purchased. The IRS agreed with this decision in *Revenue Ruling* 80-119 (1980), stating that the origin-of-the-claim test is the proper method of determining whether the settlement payment (disgorgement) is a deductible business expense, a capital expenditure or a combination of the two types of expenditures.

More than ten years after the origin-of-the-claim test was used to render disgorgement of profits a capital expenditure, the Tax Court introduced another theory into the Section 10(b) tax cases - Claim of Right Doctrine. In 1991 the Tax Court in *Barrett v. Commissioner* (1991) held that the wrongdoer was entitled to a credit under *Internal Revenue Code (IRC)* Section 1341(a)(5) in an amount equal to the decrease in tax attributable to the removal of short term capital gain from a prior year's gross income. Under Section 1341(a) if the taxpayer included

an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion of it is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under this rule, the taxpayer is entitled to a deduction only in the year of repayment or disgorgement. Pursuant to Section 1341(a)(2) taxpayer must show that he did not have an unrestricted right to the item. This can be done by showing that the taxpayer had a legal obligation to restore the item either through court awarded damages or an out-of-court arm's-length settlement.

Since disgorgement is a remedial remedy, the determination of whether it is deductible as an ordinary loss, capital loss or claim of right deduction will be done on a case by case basis. The *IRC* does not specifically address the deductibility of disgorgement of profits.

If the damage award also includes fines and/or penalties, then *IRC* Section 162(f) states that no deduction shall be allowed for such fines or penalties paid to a government for the violation of any law.

The wrongdoer is taxed on insider profits based on the tax rate that applies to his taxable income. The United States has a progressive tax rate, which ranges from 15 percent to 39.6 percent for individuals (*IRC* §§ 1(a),(b),(c) and (d)). However, for economic reasons the American government lowered the maximum rate for long term capital gains to 28 percent in order to stimulate the economy (*IRC* § 1(h)). In the United States, profits from insider trading will usually be characterized as capital gains, short-term or long-term depending on the holding period. Both short-term and long-term gains are included in total taxable income; however, short-term gains are subjected to a maximum tax rate of 39.6 percent, while long-term capital gains are subjected to a maximum tax rate of 28 percent.

If the disgorgement is treated as ordinary loss, it will be treated as a "for AGI (Adjusted Gross Income)" deduction (*IRC* § 62(a)(3)); however, if it is treated as a claim of right, it will be treated as a "from AGI" deduction under miscellaneous not subject to 2 percent (*IRC* § 67(b)(9)). Even though these deductions are different types, they both will be subjected to a maximum tax benefit of 39.6 percent. On the other hand, if the disgorgement is treated as a capital loss, it will be a "for AGI" deduction (*IRC* § 62(a)(3)). If all capital gains and losses net to a capital loss, then the $3,000 maximum deduction (*IRC* §§ 1211(b)(1) and (2)) per year will also be subjected to a maximum tax benefit of 39.6 percent.

GERMAN TAX LAW

The German tax approach, as with its securities law approach, is quite different from the American tax approach. Under the German securities law persons who engage in prohibited insider trading are not required to return the profits generated from violation of the securities laws. However, in cases where persons earned the profits by fraudulent activities, the wrongdoers usually offer to return the profits voluntarily to the court as a sign of goodwill and in an effort to decrease any possible prison sentence. Sometimes a court will order a wrongdoer to make a charitable contribution, although this does not preclude imprisonment. A third possibility is that any persons or companies which have suffered losses as a result of insider trading can sue civilly for damages. These lawsuits have a strong chance of success when the wrongdoer has already been found guilty in a criminal prosecution.

The German tax law does not allow a deduction for fines and/or penalties (*Einkommensteuergesetz* §4 V Nr. 8, 1996). Fines are defined as those imposed by a court or an official German authority or by an authority of the EC. In some cases where the fine is equal to the profits from insider trading, then the fine is deductible. In reality then, it is a disgorgement and not a fine, although there is no word in the German tax statute equivalent to disgorgement.

The wrongdoer is taxed on insider profits based on the tax rate that applies to his entire taxable income. Germany has a progressive tax rate, which ranges from 26 percent to 53 percent (*Einkommensteuergesetz* §32a, 1996). However, for political reasons the German government lowered the maximum rate for trade income to 47 percent in order to develop the German economy (*Einkommensteuergesetz* §32c, 1996). In Germany, profits from insider trading will usually be characterized as miscellaneous income, which is included in total taxable income and subject to the higher maximum tax rate of 53 percent. If the profits from insider trading are related to a trade or business, they are characterized as trade income and only subjected to a maximum tax rate of 47 percent.

CONCLUSION

The comparison of the American and German securities laws and cases showed just how different their approaches are in regulating insider trading. The American approach is to define prohibited insider trading through case law. The drawback in this approach is that persons will be prosecuted for a crime that is undefined by statute. On the other hand, a statute defining insider trading would allow for discovery of loopholes in the definition. Although no statute exists, the case law has defined insiders narrowly as evidenced by the "fiduciary duty" standard in the *Chiarella* case.

The German approach is to specifically define prohibited insider trading in the law. Completely contrary to the American approach, this new law defines insiders very broadly. For instance, the printer in the *Chiarella v. U.S.*, an American case, would be an insider based on German law because he obtained the nonpublic information in the due course of his profession.

With such differing approaches to the regulation of insider trading, the potential for market manipulation and failure is quite high. This problem will only be exacerbated as the United States and Germany increase their commercial relationship and their global investments escalate.

The tax consequences of the American and German regulation of insider trading are quite different. The American insider is required to return the profits ("disgorgement") in order to prevent unjust enrichment. The determination of whether the return of profits is tax deductible is dependent on case law. In contrast, the German insider is not required to return the profits and thus the question of deductibility need not be addressed. Other dissimilarities include the characterization of profits, the taxation of profits, and the tax rates. However, the most important similarity is the nondeductibility of fines and penalties.

Only time will tell how the American securities/tax case laws and the German securities/tax statutes actually will evolve given the significant international trading between the United States and Germany.

NOTES

1. The main regulations are set forth in Part 3 of *Gesetz überden Wertpapierhandel.*
2. Translation of the German Act on Securities Trading (*Securities Trading Act* - WpHG), Chapter 3, § 13 (Insiders):

   (1) An insider is anyone who

      1. as a member of the management body (Geschäftsführungsorgan) or supervisory body (Aufsichtsorgan) or as general partner (persönlich haftender Gesellschafter) of the issuer or an enterprise associated with the issuer (verbundenes Unternehmen), or
      2. by virtue of his participation in the share capital of the issuer or of an enterprise associated with the issuer or
      3. by virtue of his profession or his activity or his assignment in due course has obtained knowledge of circumstances not known to the public relating to, or to one or more issuers of, insider securities which, if becoming known to the public, may materially affect the price of such securities (inside information).

   (2) An assessment (analysis) which is compiled exclusively based on publicly known information shall not be deemed inside information, even if such assessment might materially affect the price of insider securities.
3. Id.
4. Id.; see also, Höpt, Klaus J.: Insiderwissen und Interessenkonflikte im europaischen und deutschen Bankrecht, in: Kübler, Friedrich Werner, Winfried/Mertens, Hans Joachim (Hrsg.): Festschrift für Theodor Heinsius, Berlin, 1991, S. 289-322, hier S. 289.
5. Internal Revenue Code Section 1222(1): Short-term capital gain means gain from sale or exchange of a capital asset held for one year or less; *Internal Revenue Code* Section 1222(3): Long-term capital gain means gain from sale or exchange of a capital asset held for more than one year.

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