

LIABILITY FOR USE OF INSIDER INFORMATION IN THE FRAMEWORK OF CORPORATE GOVERNANCE: A COMPARATIVE ANALYSIS OF EUROPEAN, AMERICAN AND RUSSIAN LEGISLATION

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ABSTRACT

Discussion on the using of insider information in the process of implementation of corporate governance is important not only for Russia, but also for those countries which have the laws governing this activity not for the first year. This article is devoted to the review of legislation governing the activities with the using of insider information. Similar legislation operates in countries with a long history of their use, in particular the United States, France, Great Britain, and in states where the law in question is relatively recent (these countries are Germany, Russia). The main attention is paid to the special status of subjects of the prosecution, because the definition of insider information in the legislation of different countries does not cause serious difficulties and varies to a greater extent the formal features, but it cannot be said about what the definition given by the insider is.

1. INTRODUCTION

“Insider trading” is a term that most investors have heard and usually associate with illegal conduct. But the term actually includes both legal and illegal conduct. The legal version is when corporate insiders — officers, directors, and employees — buy and sell stock in their own companies.

By 2000, the financial market existed in 103 countries, in 87 of them passed a law regulating the activities with the use of insider information. It’s no secret

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that most European countries have adopted this law in the last decade of the last century as a result of the changes taking place in the global economy and the global financial market. For example, Germany adopted a law on insider information as one of the last member-countries of the European Union, primarily guided by the desire to strengthen the position of the Frankfurt Stock Exchange as a leading financial center in continental Europe and improve the country's reputation with attractive financial climate.

Globalization of the world economy and financial markets more noticeable highlights the need to harmonize the legal regulation of these processes. The European Union has made significant progress in this direction through the legislation related to insider activity in the territory of the European Union. The Directive on Insider Dealing is a vivid example.

Development of new technologies and the use of the internet have made the world financial markets more accessible to investors. At the same time, this mobility facilitates unscrupulous investors the opportunity to evade responsibility for the committed offence. Such offences associated with the use of insider information activity are no exception. Therefore, joint efforts of countries to identify unscrupulous investors are particularly important.

At present, Russia does not use its full potential to attract investment. Lack of adequate legal regulation of using insider information has bad influence on the investment attractiveness of the country. Of course, the adoption of a law on insider information¹ solved some of the problems faced by investors in financial markets, but certainly at the moment is necessary to adopt additional measures that will enhance the country's status.

2. RESPONSIBILITY FOR USE OF INSIDER INFORMATION - COMPARATIVE ANALYSIS

It is obvious that the law of any country has its own characteristics, due to its economic, historical and cultural development. This in turn affects not only the details of the legislation, but also the process of its development. For example, in the European Union, Australia and Japan adopted legislation specifically aimed at regulating exactly insider activity. At the same time, the US laws governing insider activity are the result of administrative and judicial interpretation of the rules governing fraud and deceit. This difference makes US law more dynamic and flexible to all 'unusual' situations using insider information

¹ The Federal Law of 27.07.2010 N 224-FZ "On combating unauthorized use of insider information and market manipulation and on Amendments to Certain Legislative Acts of the Russian Federation." "Rossiyskaya Gazeta", N 168, 30.07.2010.

arising in the financial market. Despite the possible differences, the main provisions of legislative acts are similar in substance and could be successfully used in making laws in the countries where such standards are absent.

3. WHAT INFORMATION RECOGNIZED INSIDER

Review of the legislation of countries with developed financial market has shown that the nature of the information used in stock transactions, is a key feature for which the law classifies it in the category of insider. Thus, the laws of all countries surveyed previously contain two attributes for which information is deemed insider: information must be relevant, meaningful and accessible to a wide range of investors. Despite the resemblance of these features, interpretations are sometimes different.

For the law of the European countries it is common that the definition of insider information has two main requirements: the information must be relevant so that may impact the market value of the shares, and is not available to a wide range of investors.

Japanese legislation devoted formal side of the issue to defining value. For example, Japanese law does not contain a clear statement of what information is necessary to recognize the insider, and provides a list of facts on non-disclosure of which involves responsibility for the use of this information². According to the law, corporation in the manner prescribed by law shall disclose information concerning its activities, if it contains facts, included in the list of law subject to mandatory disclosure. The Corporation is required to follow these requirements even if these facts are already known to interested investors³.

The US law governing insider activity is not integral law, as in most of countries, but the set of regulations and judicial decisions, which lacks a clear statement of what information deemed insider. Nevertheless, in practice, there is the concept of judicial 'essential, important information' that is widely used by judges in deciding guilt of person for use of the information in transactions with shares.

Sometimes there is the external similarity of the approaches of the laws of different countries as to what information is considered insider. It is difficult to determine when publicly available information has to be recognized as sig-

² Tomoko Akashi. Note. Regulation of Insider Trading in Japan, 89 Colum. L. Rev. 1296. 1989.

³ Ibid

nificant, so that its use will be grounds for bringing a person to justice. In the United States and Australia is applied a broader interpretation of the concept 'substantial'. For example, in the United States is recognized the importance of information, which is essential if the average investor expects that this information may affect the stock price changes⁴.

A similar approach to the concept of 'substantial' is used in Australian law. It recognizes the essential information as such, when from the point of view of the average investor can affect the price of the shares or his decision to purchase/sale shares⁵. The presence in the formulation of the valuation concepts as 'the decision to buy / sell shares', sets it apart from all the others and provides an additional opportunity for loose interpretation of the facts by both parties.

European Union legislation, at first glance, gives a more detailed definition of material information, although, in fact, it is not much different from the language used in the legislation of other countries. Thus, according to the definition of 'significant' is information that is accurate. It refers to the issuer or directly to the shares and can significantly affect the price of traded securities⁶. This definition raises doubts about the desirability of the requirement to ensure that the information necessarily apply to the Issuer or the shares directly. Is someone going to buy or sell shares, using the information without any relation to this transaction?

The differences in the wording of such significant responsibility for regulating the concept of 'essential information' may have different consequences. For instance, the Japanese law, with its limited list of facts to be disclosed, enables the person concerned to select a more flexible behavior in the handling of information. In turn, the standard approaches are based on the behavior of the average investor, resulting in greater predictability of who can be held accountable.

Giving advice on what definition of insider information may be most appropriate for the Russian legislation regulating insider activity, it is important to include the following key requirements:

1. the information must contain undisclosed information which at the request of the legislator must be disclosed to a wide range of investors;

⁴ Basic, Inc. v. Levinson, 485 U.S. 224. 1988.

⁵ Corporations Act. 1998. § 1002C. 1002G(1)(a) (Austl.); Ampolex, Ltd. v. Perpetual Trustee Co., Ltd., 1996 NSW LEXIS 2827.

⁶ Council Directive 89/592 of November 13, 1989; Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30.

2. information should be of such nature that their disclosure may affect the market value of the securities.

4. WHO CAN BE HELD LIABLE FOR USE OF INSIDER INFORMATION?

If the definition of 'inside information' in the legislation of different countries does not cause serious difficulties although varies to a greater extent, the same cannot be said about the definition given by insiders. It affects primarily the concept of the underlying rules governing insider activity. One of the basic theories is the concept of information asymmetry. Its essence lies in the fact that one side of the transaction, having more information about the subject of the transaction, is aware that the other side of the same transaction would not participate in it, if it had more information because the transaction is considered to be unfair.

If you do not talk about the moral aspect of the transaction where one party simply cheating in relation to the other, from the point of view of the theory of economic efficiency of the transaction, which simply moves the wealth of uninformed side to well-informed side, is a bargain with zero efficiency. Both sides benefit more from the deal if the information is provided to both parties. Awareness that someone would be likely a victim of an unfair bargain reduces interest in investment, which in turn makes the elusive goal of creating an attractive financial market with high liquidity. It is difficult to dispute the fact, that the information itself is valuable, if nothing else for the time spent, to get it. Directors and employees have access to internal information of the company - which is not open to other investors - primarily due to the performance of their duties. In other words, their privileged position in relation to other investors is not the result of further analytical work, than due to the fact that these people 'were' in the right place at the right time. Although the use of word 'were' is not entirely correct, because these people by virtue of their official duties had to have this information.

Against the background of the above use of the theory of equal access to information that is used as a basis of liability in the Australian legislation is justified⁷. Some of the difficulties of this theory are related to the uncertainty of the concept of 'equal access'. Analytical skills of one person may largely differ from the abilities of other people; other things being in equal conditions

⁷ Roberta S. Karmel, *Transnational Takeover Talk-Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. Cin. L. Rev. 1133, 1148-1149. 1998.

can lead to a completely opposite decision. This situation has a right to exist, if both participants in transaction are initially in the same conditions of access to the information. If one party in the transaction, using the preferential access, uses the additional information in the decision and the other party does not have more information, then there is a violation of the principle of equal access, which implies an offensive liability.

In the Australian legislation, this problem is solved by limiting the liability only for those cases where the violation of the principle of equal access to information is clear, and there is no legal justification for the use of insider information without disclosure.

The European legislation offers an alternative to its use of the theory of equal access. Thus, Directive on Insider Dealing provides for liability of directors, shareholders and other persons who possess inside information, basing on the fact that these individuals perform their official or professional duties. The rationality of this approach is due to the fact that it is in this group of people more likely to be involved in the transaction with the use of insider information. So, it can be concluded that such a non-specific definition of the concept 'insider' is related to the small number of transactions that have been made possible due to other reasons than the violation of the principle of equal access to information.

At first glance, the approach to the regulation of insider activity in the US, which is also built on the theory of equal access, not much different from the approach taken in the European Union. However, in the United States is not enough the fact that a person has or, on the contrary, has not access to the information. The basis for the prosecution can be a silent person, if it is equivalent to the silence of the misrepresentation, which in turn escalates to a violation of key provisions of the US corporate law that directors, top managers of the companies, as fiduciaries of shareholders are required to justify such trust⁸.

The decision of the US Supreme Court in the case *Chiarella*, best demonstrates the features of accountability for the use of insider information in the United States. *Chiarella* worked in an organization that provides services to financial companies. Among his clients were companies in whose intention was to bid buy off shares of the several companies at the price higher than the market.

Despite the fact that the client-company left empty graph with the name of the company whose shares is going to buy, the documents were for printing.

⁸ Shirinyan I. World experience of using insider information on the securities market // RZB. 2004. N° 13. p. 38-42.

Chiarella using information from other documents guessed of which company shares will be the subject of transaction, and bought shares worth about 30 thousand dollars prior to the announcement of transaction. SEC found this deal, and Chiarella was prosecuted for violation of the norms stipulated by Section 10 (b) and Rule 10b-59. The Supreme Court reversed verdict of the lower court and acquitted Chiarella⁹. So, the different solutions were due to the different approaches. In accordance to the rules of procedure before verdict the judge must instruct the jury on which key points should be based their decision. In the case of Chiarella judge recommended that the jurors pay attention to the fact that the perpetrator when buying shares used material information not disclosed to the wide range of investors, and thus knew that the other market participants did not have access to this information. The Supreme Court reversed the lower court decision, noting that in the case of application of the theory, Chiarella's equal access to the information was wrong. The Supreme Court based his decision on the fact that insider has primarily trusting relationship with the shareholders of the company, of which he is an employee. In this case, Chiarella was not insider of the company whose shares he acquired, and moreover he did not obtain the information from the insider.

Thus, the Supreme Court concluded that Chiarella, in the sense of requirements of the US corporate law, had no obligations toward the company and its shareholders. Thus, according to the Australian and European legislation Chiarella was not guilty, and could not be held responsible for the misuse of information received by chance. The difference lies in the same Elaborate American legislation on the use of insider information, as a consequence of the important role played by financial markets in the United States.

With regard to bringing to justice those who have received information from insiders, according to the rule of equal access to information in its interpretation any Australian person possessing substantial range of undisclosed information from investors, are not allowed participating in deal. In the legislation of the countries of the European Union there is also a clear position, which prohibits secondary insiders make transactions¹⁰ and adheres to the regulations, that any person, who has received information from an insider, automatically assumes the obligation not to commit insider transaction. In accordance with the laws of Japan, in addition to traditional quasi insiders liable for the use of inside information may be held entities affiliated companies, as well as civil servants who have received insider information as a result of the business relationship with the company.

⁹ Chiarella v. United States, 445 U.S. 222. 1980.

¹⁰ Shirinyan I. World experience of using insider information on the securities market // RZB. 2004. N° 10. p. 74.

The jurisprudence of the United States has the most detailed approach to the question of guilt of a person who is not an insider. So, significant is the case *Dirks*, who was the financial analyst of brokerage house¹¹. *Secrist*, the former employee of the financial companies *Equity Funding*, told *Dirks* about large-scale fraud plot in the company, where he previously worked, hoping that *Dirks*, because of his professional duties, would reveal this fraud scheming. *Dirks* has warned its client's brokerage firm about this fraud, which allowed them to get rid of the shares of *Equity Funding* before information about the machinations became widely known.

Despite the fact that the SEC considered *Dirks* guilty of distributing insider information to clients of brokerage company (which allowed them to sell the shares before the drop in price), the Supreme Court reversed the decision, citing the fact that only an insider has obligation to disclose information to the commission for transactions. At the same time, in the case *O'Hagan* Supreme Court issued decision that the lower-level managers, as well as other employees of the company, although not having access to confidential information, but have such various reasons and use it to generate income in the transaction with company's shares will be found guilty of violating the trust of his employer¹². Further development of jurisprudence in the United States and the emergence of the theory 'misappropriation of information'¹³ demurred the approaches in European and American law in bringing to justice those who are not insiders in the classic sense.

The Russian legislation has also need to distinguish two groups of persons who may be held liable for insider activity - the direct insiders and the persons in possession of insider information. As 'insiders' should be included persons who have access to insider information by virtue of their official or professional duties. To the persons in possession of the insider information should be included all those who actually own the insider information.

5. ACTIVITIES REGULATED BY LEGISLATION ON INSIDER ACTIVITY

Defining 'actions using insider information is unlawful', does not cause too much trouble, and is similar in the legislation of different countries. Thus, it is generally accepted that a person has no right to make transactions with securi-

¹¹ *Dirks v. SEC*, 463 U.S. 646. 1983.

¹² *United States v. O'Hagan*, 117 S. Ct. 2199. 1997.

¹³ Shirinyan I. World experience of using insider information on the securities market // *RZB*. 2004. N° 13. p. 38.

ties using insider information. The differences begin with the fact that in some countries, such as the United States and the European Union, to be considered as illegitimate it is necessary that person not just owned information but also use it in the transaction. In Austria and Japan, on the contrary, to prosecute someone is enough that he/she only possess the inside information, which automatically implies its use in the transaction.

It is more complicated to deal with bringing to the justice insiders who forwarded insider information to third parties. Under the Australian law a person is subject to law suit for transfer of insider information to any third party, if the person who transmits the information knew or should have known that the third party will use this information to buy or sell securities. Japanese law is more loyal and provides for liability for the transmission of information only for insiders.

In accordance to the US law of the prosecution, it is important to establish the fact of material interest of the person who sent the information. The legislation of the European Union, as a rule, does not request liability for the transmission of information by the quasi-insiders. If insider has passed the information, it would be the basis for liability. The laws regulating insider activity have in common the presence of personal intent in action or awareness of using insider information when making transactions in securities.

The Russian law governing insider activity can serve as a prototype for the Australian model of accountability for the use of insider information. According to this model, the person will be persecuted based on ownership of information, as well as for the transfer of insider information to any third party, if the person who transmits the information knew or should have known that the third party will use this information to buy or sell securities. Intent or awareness in the use of insider information must also be a prerequisite bring the person to justice.

6. FEATURES OF LIABILITY PROVISIONS IN THE JOINT RUSSIAN MODEL OF CORPORATE GOVERNANCE

The Russian corporate law is still not resolved the issues of using insider information. Meanwhile, the stock market takes a regular manipulation of stock prices. According to the Federal Law “On the Securities Market”, the circle of persons possessing inside information is quite narrow and does not cover, for example, members of the Board of Directors and the Audit Commission, the major shareholders. Currently, the Federal Law “is combating unauthorized use of insider information and market manipulation”. It provides a clear definition of “insider information”, as well as a list of securities in respect to which it

is possible to use the service information, introduces a number of restrictions on its use, expanding the circle of insiders due to the inclusion of not only the company officials, but also the public employees who have access to the database of the issuer.

The main priority of the Russian legislature at this stage is to establish a clear legal framework for the settlement of corporate conflicts, the creation of civilized mechanisms of mergers, acquisitions and reorganization of the company, define the criteria for affiliation, the regulation of the use of insider information. In other words, clearing the “platform” for the formation of a favorable external environment, without which, for the country aspiring to the full-fledged system of corporate governance, that is hardly possible.

April 18, 2014 Bank of Russia Bulletin submitted information intended for joint-stock companies, public corporations and companies that: “on March 21, 2014 Board of Directors of the Bank of Russia approved the Corporate Governance Code (hereinafter - the Code). The Code recommends that the Bank of Russia to the use of joint-stock companies, whose securities are admitted to organized trading. Additionally, we have to inform that the draft Code of Corporate Governance was approved, mainly by referring to the recommendation, at a government meeting February 13, 2014 “.

The Code was approved by the Board of Directors of the Bank of Russia, and was fully approved, when the Bank of Russia in a letter from 04.10.2014, recommends the Code for public joint stock company. It was reported, that at a meeting of the Russian Government 02/13/2014 Code “was approved mainly with the reference to his advisory nature.”

In this connection, in our opinion, is the unresolved question of how much of the code is outside the “approved in principle“, meaning that is not fully approved by the Russian Government. It is also unclear why the Code recommended by the Bank of Russia to the full application of the Company’s shareholders, was recommended as “substantially”. These issues become even more relevant by giving the mandatory status of the Code, to implement the document in a number of state-owned companies. And in the light of the information, that are now being discussed plans for “implementation” (that is, in our view, the obligation) of the Code for all Russian public companies, these issues cannot continue to be unclear. The Code currently is the largest paper of its kind in the world, but most of the provisions of the Code is declarative in nature.

Since 2014 the Code was by judicial practice interpreted as a custom of business practice. Currently, the authorization of acts or decisions are clearly outside of the custom that may be, for example, the basis for recognition of the

decision of the board of directors of the company as invalid. This Code sets a certain standard of conduct, where a clear deviation would allow the court to protect the interests of the person (a shareholder, a member of the Board of Directors).

7. COOPERATION AMONG INTERNATIONAL LAW ENFORCEMENT AUTHORITIES

Insider trading often crosses borders: a foreign citizen engaged in insider trading on the domestic market; nationals affect insider trade through the foreign accounts; or important evidence of domestic insider trading lies outside domestic borders.

Successful investigations and prosecutions of these cases require international cooperation. Perhaps one of the most progressive aspects of the EC Directive is, that it requires of the members to cooperate with each other “whenever necessary for the purpose of carrying out their duties” in connection with the EC Directive. The significant benefit of this provision is that it requires no further agreements between or among states regarding cooperation.

The SEC has entered into 32 arrangements with foreign counterparts for information sharing and cooperation in the investigation and prosecution of securities law violations. These agreements have taken primarily two forms: Mutual Legal Assistance Treaties in Criminal Matters and Memorandum of Understanding.

The United States have entered into Mutual Legal Assistance Treaties with numerous countries, including Switzerland, the United Kingdom, the Cayman Islands, the Netherlands, Turkey, Canada, the Bahamas and Italy. The treaties generally provide assistance in the criminal matters, including assistance in locating witnesses, obtaining statements and testimonies of witnesses, production and authentication of the business records and service of judicial and administrative documents. The major advantage of these treaties is that they are binding for the parties in the treaty.

The other form of agreement on which the United States has relied, in the international context, is the Memorandum of Understanding. MOU is non-binding statement of intent between regulators providing for the exchange of information and mutual cooperation. The Commission has entered into MOU or similar agreements with Switzerland, Japan, the U.K., Brazil, the Canadian Provinces of Ontario, Quebec and British Columbia, Italy, the Netherlands, France, Mexico, Portugal and Germany. Experience has shown that MOUs provide effective means of obtaining information in securities, enforcement

and assist in developing a framework for cooperation and improved communication.

At home, the United States has passed laws to facilitate its cooperation with foreign governments. The Insider Trading and Securities Fraud Enforcement Act of 1988 expanded the Commission's ability to provide assistance to the foreign regulators by allowing them to use their compulsory powers to compel testimony and production of documents obtain information at the request of a foreign securities authority.

The International Securities Enforcement Cooperation Act of 1990 enlarged the Commission's ability to address international securities issues in several ways. It amended the securities laws to permit the Commission to institute an administrative proceeding barring, sanctioning, or otherwise placing conditions on a securities professional's ability to engage in Commission-regulated activities if a foreign court or securities authority has found that the professional engaged in illegal or improper conduct. The law also amended the securities laws in order to provide confidential treatment for records produced under reciprocal arrangement with foreign securities authorities by exempting the documents from the disclosure obligation of the Freedom of Information Act if a good faith representation is made that disclosure would violate that country's confidentiality requirements. In addition, the law makes explicit the Commission's rulemaking authority to provide access to non-public documents and other information to both foreign and domestic authorities. Finally, it authorizes the Commission to accept reimbursement from a foreign securities authority for expenses incurred by the Commission in providing assistance.

In 1997, the SEC made 240 requests to the foreign governments for enforcement assistance and responded to 363 requests for enforcement assistance from the foreign governments¹⁴.

In the summer of 1998, the SEC had notable success in obtaining information under the Hague Convention, which prescribes certain procedures by which a judicial authority in one contracting state may request evidence located in another contracting state in civil cases¹⁵. In an emergency action filed in the Southern District of New York, the Commission filed complaint against two Singapore residents, alleging that the defendants engaged in insider trading prior to the public announcement that APL Limited would be acquired by Singapore-based Neptune Orient Lines, Ltd. The court granted the Commission's

¹⁴ Martinson Jane, *Powers Against Crime Will Reflect SEC's Sanctions*, The Financial Times (London), July 31, 1998, at 11.

¹⁵ The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, Mar. 18, 1970, 23 U.S.T. 2555.

request for a temporary asset freeze and orders requiring the defendants to identify themselves, allowing expedited discovery, and granting other ancillary relief¹⁶.

The Commission applied to the High Court of the Republic of Singapore under the Hague Convention for the appointment of an examiner to take evidence from witnesses in Singapore, to be used in the proceeding in the Southern District of New York. The Singaporean defendants opposed the appointment of an examiner, arguing that despite the U.S. classification of the action as civil, violations of Section 10(b) and Rule 10b-5 are penal in nature and, therefore, the Hague Convention does not apply. The Singapore court held for the SEC, finding that an action for an injunction under Section 10(b) and Rule 10b-5 is a civil proceeding according to the law of the United States and the law of Singapore. This decision, if followed in other Hague signatory countries, opens yet another mode of international information-gathering available to the SEC's enforcement program.

8. CONCLUSION

The European Union has formally recognized the importance of insider trading prohibitions by passing directive requiring its members to adopt insider trading legislation. The preamble to the directive stresses the economic importance of a healthy securities market, recognizes that maintaining healthy markets requires investor confidence and acknowledges that investor confidence depends on the "assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information."¹⁷ These precepts echo around the world as reports of increased insider trading regulation and enforcement efforts are daily news.

The EC has accomplished something that the U.S. Congress has not been able to accomplish. By defining specifically the persons and transactions covered by insider trading prohibitions, the EC Directive provides certainty in the rule of law not found in the United States counterpart. Interestingly, much of the theory underlying the EC Directive was adopted from the United States case law. Congress should follow the EC approach and codify the law, thereby providing needed certainty and coherence.

¹⁶ SEC v. One Unknown Purchaser of the Call Options of APL Limited and Ong Congqin Bobby, 97 Civ. 2664 (S.D.N.Y. April 15, 1997), Litig. Rel. No. 15334.

¹⁷ Council Directive 89/592 Coordinating Regulations on Insider Trading, 1 Common Mkt. Rep. (CCH)

In conclusion, it should be noted that the effectiveness of legislation governing insider activity, primarily due to the goals that were set by the legislator after his admission. The mere existence of such legislation does not guarantee unconditional increase in investment activity and improve the liquidity of the financial markets, while protecting the rights of investors and a level playing field in the financial market will contribute to its development.

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