Introduction

The "Decade of Greed" was in full swing when Gerald Guterman, a wealthy real estate developer, rented out the entire *Queen Elizabeth II* for his son's bar mitzvah in September 1986. New York City's rich and famous gathered for the event. As the *QE2* pulled into the Hudson River, some guests no doubt gossiped over their champagne about the fact that one of the more celebrated invitees had missed the boat. Then, as James Stewart masterfully described, the guests looked up as a

> helicopter came into view, hovered over the ship, then descended to the sports deck helipad. With the blades still turning, the cockpit door opened, and [Ivan] Boesky, elegantly dressed in a tuxedo and black tie, stepped onto the deck. He flashed a smile and waved as guests laughed and applauded.[1]

The very next day, Boesky – the man who served as the model for Oliver Stone's Gordon Gekko in the iconic Hollywood film *Wall Street*, and who is famous for telling an audience of UC Berkeley Business School students that "greed is healthy" – surrendered to federal agents on charges of insider trading and other financial crimes.

As a former director of enforcement at the Securities and Exchange Commission once noted, "insider trading has a unique hold on the American popular imagination."[2] Newspapers give it front-page coverage. Best-selling books are written about it. Cult movies romanticize and demonize it. Politicians make their careers and fortunes by pillorying, enforcing, and (incidentally) engaging in it. But, oddly, no one seems to have a clear sense of what is wrong with it. As one prominent insider trading scholar once put it, the "short answer to the question of why insider trading is illegal is the one that an exasperated parent is wont to give a misbehaving child:

[1] James B. Stewart, *Den of Thieves* (New York: Simon & Schuster Paperbacks, 1991, 2010): 265.
[2] See Laura E. Hughes, "The Impact of Insider Trading on Stock Market Efficiency: A Critique of the Law and Economics Debate and a Cross-Country Comparison," *Temple International & Comparative Law Review* 25 (2009): 488 (quoting Linda Chatman Thomsen).

'Because it is!'"[3] This answer is, however, hardly satisfying to individuals facing more than ten years of prison time for the offense. What is even more perplexing and disturbing is the fact that, since Congress, the SEC, and the courts have failed to define it with specificity, no one seems to have a clear understanding of what insider trading is.

Michael Lewis, the best-selling author of *Liar's Poker*, *The Big Short*, and *Flashboys*, explained in a recent interview that he has "always thought insider trading is a great distraction." According to Lewis, "whenever things go bad on Wall Street, the one thing that prosecutors know how to prosecute is insider trading, so they go looking for insider traders." But, Lewis went on, insider trading "has very little to do with the problems that . . . have led to the [recent] financial crisis."[4] Indeed, in the wake of the 2008 financial crisis, United States Attorney for the Southern District of New York Preet Bharara seemed almost single-minded in his focus on insider trading, achieving a near-perfect conviction rate in more than seventy insider trading cases, with judges in some cases imposing sentences greater than those mandated for violent robbery or rape.[5] This prosecutorial success put Bharara on the cover of *Time* magazine as the man who is "Busting Wall St.,"[6] but it did nothing to address the causes of the financial meltdown that caused so much pain and frustration for "Main Street" America.[7] For some mysterious reason, insider trading regulation has become what Professor Donald Langevoort has termed a "powerful totemic symbol" of the government's championing of the rights of average investors in American securities markets. As such, it has "taken on an expressive value far beyond its economic importance," a value that judges have been "reluctant to undercut."[8] As Professor James Cox once put it, "American jurisprudence abhors insider trading with a fervor reserved for those who scoff at motherhood, apple pie, and baseball."[9]

Given the recent vehemence of insider trading enforcement in the United States, and its symbolic importance for our culture, it is no longer acceptable to leave unanswered the crucial questions of "What is insider trading?," "Why is it wrong?,"

3 Peter Henning, "What's So Bad about Insider Trading?," *The Business Lawyer* 70 (2015): 770–71.

4 CNBC interview of Michael Lewis, December 6, 2016, https://finance.yahoo.com/video/lewis-insider-trading-great-distraction-183400745.html.

5 See Charles Gasparino, *Circle of Friends* (New York: Harper Collins, 2013): 155. ("Under the federal guidelines, the maximum sentence for insider trading is nineteen to twenty-four years, while a rapist could get fifteen years to life in prison.")

6 "This Man Is Busting Wall St.: Prosecutor Preet Bharara Collars the Masters of the Meltdown," *Time* (February 13, 2012), http://content.time.com/time/covers/0,16641,20120213,00.html.

7 Indeed, "[n]ot a single major financial executive faces jail time for crisis-related crimes. . . . And yet the news of the day is the dramatic rise in cases of insider trading." Gasparino, *Circle of Friends*, 13.

8 Donald C. Langevoort, "'Fine Distinctions' in the Contemporary Law of Insider Trading," *Columbia Business Law Review* 2013 (2013): 433.

9 James D. Cox, "Insider Trading and Contracting: A Critical Response to the 'Chicago School'," *Duke Law Journal* 1986 (1986): 628.

and "Whom does it harm?" Uncertainty over these questions has led to a growing consensus that the insider trading enforcement regime in the United States, the oldest in the world, is in need of critical reevaluation and reform.[10]

This book has four principal goals. First, it contextualizes the problems facing insider trading enforcement in the United States by tracing the development of the current law from its historical antecedents, and by comparing it to regulatory regimes in other countries. Second, it argues that the American insider trading enforcement regime is broken. Ambiguity in the law has led to uncertainty for issuers and other market participants. This uncertainty directly impacts shareholder value and unjustly leaves market players at the mercy of prosecutorial caprice. Third, the book sets the stage for intelligent reform by providing a comprehensive answer to the question, "What is wrong with insider trading?" All forms of insider trading currently proscribed by law are tested from the standpoints of economic, moral, and virtue theory. It turns out that while some forms of insider trading are indeed harmful and wrong, one form, issuer-licensed insider trading, is economically beneficial and morally permissible. A key component to fixing the current regime will be to ensure that it proscribes only morally culpable and harmful insider trading. Fourth, the book proposes a concrete path to reform. The final chapter draws upon the historical, empirical, comparative, and normative conclusions reached in previous chapters to shape a comprehensive program for statutory reform that would improve upon the current regime in terms of justice, efficiency, and rationality. The chapter-by-chapter development of these goals proceeds as follows.

Chapter 1 traces the early development of insider trading law from its nineteenth-century state common law origins. These early cases were typically brought as private contract claims concerning face-to-face stock transactions. No uniform approach to insider trading cases had developed by the time of the stock market crash of 1929. A majority of jurisdictions did not recognize a fiduciary or other duty that would preclude senior management from availing themselves of material nonpublic information while trading in their firm's shares. Special facts (such as affirmative misrepresentations or concealment) might give rise to an equitable duty for insiders to disclose information to counterparties in face-to-face transactions, but not over anonymous exchanges. A growing minority of jurisdictions were, however, prepared to recognize a fiduciary duty for senior management to disclose material nonpublic information asymmetries prior to any face-to-face transaction in the firm's shares, but not necessarily when trading over anonymous exchanges. These minority jurisdictions did not, however, recognize trading restrictions for low-level insiders,

[10] See J. Kelly Strader, "(Re)Conceptualizing Insider Trading," *Brooklyn Law Review* 80 (2015): 1420–21. ("Recent insider trading enforcement efforts have been unparalleled in their scope and impact, producing the lengthiest insider trading sentences in history and pushing the boundaries of existing law. Largely because of these efforts, insider trading law and policy could well be on the brink of substantial transformation.")

and no jurisdiction imposed civil fines or criminal liability for insider trading prior to the implementation of the federal statutory regime.

Chapter 2 picks up the development of insider trading law in the wake of the market crash of 1929, when the seeds of the modern federal insider trading regulatory regime were planted with the promulgation of the Securities Exchange Act of 1934. The relevant provisions of the Exchange Act failed to reference insider trading (as we understand it today), much less define it as a crime. Congress was simply not concerned about it at the time. The modern insider trading enforcement regime was principally an invention of the Securities and Exchange Commission in the exercise of its authority to implement the general antifraud provisions of the Exchange Act in the early 1960s. The law's subsequent development has been almost entirely a matter of SEC rulemaking and federal common law. It was not until *SEC v. Texas Gulf Sulphur* (1968)[11] that the federal courts recognized insider trading as illegal pursuant to Section 10(b). And the modern insider trading framework was not fully recognized by the US Supreme Court until much later in *United States v. O'Hagan* (1997).[12] The current American insider trading enforcement regime is therefore far from deeply rooted in the nation's history and traditions. The first two chapters paint the picture of an enforcement regime that is very recent in its development and anything but linear in its progression.

Section 10(b) of the Exchange Act is an antifraud provision, and the Supreme Court has made it clear that insider trading liability pursuant to that statute must therefore satisfy the elements of common law fraud. In *O'Hagan*, the Court recognized two theories of Section 10(b) insider trading liability as fraudulent nondisclosure: (1) the classical theory, which covers trading in an issuer's shares by its employees or those closely affiliated with it, and (2) the misappropriation theory, which addresses outsider trading, or trading by persons who are not employees or otherwise affiliated with the issuer (though it can be applied to insiders as well). Liability under either of these theories requires that one seek to benefit from trading on the basis of material nonpublic information in violation of a fiduciary or other similar relation of trust and confidence. Chapter 3, however, identifies an important problem. Neither the SEC nor the courts have offered a clear account of when a "relation of trust and confidence" arises, when information is "material" or "nonpublic," when one has traded "on the basis of" that information, or even the mental state required for Section 10(b) insider trading liability. Worse still, what little guidance the SEC has offered in interpreting these key elements is often at odds with the guidance provided by the federal courts.

Chapter 4 explains how this ambiguity and confusion in the law of insider trading in the United States has yielded a regime that is unjust, incoherent, and irrational. It is unjust because vagueness in the law violates the time-honored "principle of

11 S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (1986).
12 United States v. O'Hagan, 521 U.S. 642 (1997).

legality," which demands that persons be given reasonable notice prior to the imposition of legal sanctions. Uncertainty in the law of insider trading grants regulators and prosecutors vast discretion in defining the scope of liability, leaving even well-meaning market participants with little ex ante certainty concerning the legality of their trading. The insider trading enforcement regime in the United States is incoherent because the SEC and the federal courts continue to explain and justify it by appeal to two irreconcilable theories. The SEC pushes for a parity-of-information or equal-access insider trading regime, while the courts insist that the statutory authority for the regime in Section 10(b) demands that it be based on the fraudulent breach of fiduciary duties. This tension has led to a schizophrenic regime that is both under- and over-inclusive when measured by either model. Finally, the insider trading regime in the United States is irrational because ambiguity and incoherence in the law translate into uncertainty for issuers in the design and implementation of their insider trading compliance programs, which typically leads firms to adopt an overbroad, "play-it-safe" approach. This conservative approach to compliance, however, comes at a heavy price in terms of corporate culture, cost of compensation, and share liquidity. All of these costs have a detrimental effect on shareholder value. Moreover, it will be shown that the broad scope for derivative corporate criminal liability under the current regime sometimes leaves the victims of insider trading liable for the crimes perpetrated against them. For these and other reasons laid out in Chapter 4, the current US insider trading enforcement regime irrationally undermines many of the goals it was intended to promote, and is therefore in need of reform.

Having summarized the current state of insider trading law in the United States and the need for its reform, the book devotes its remaining chapters to outlining a path forward. In anticipation of reform, it is prudent to consider the experiences of other nations in regulating insider trading and to determine what if any lessons might be learned. Chapter 5 therefore offers a survey of insider trading enforcement regimes outside the United States. Prior to the 1980s, most countries left insider trading virtually unregulated. Partly due to US influence, the regulatory tableau has changed dramatically over the last three decades. Today, the vast majority of countries have insider trading laws on the books. These regimes vary significantly in their scope, reach, and enforcement (or lack thereof). The comparative study of these regimes offers ideas and suggests innovations for improving the US regime, but the lack of enforcement and problems of regulatory ritualism in other countries also give grounds for caution against drawing strong conclusions from the global experience. To justify and motivate enforcement, the ethical and economic rationales for the law and its limits must be made explicit – they cannot be assumed. The goal of Part II of this book is to give clear expression to the normative stakes of insider trading and its regulation.

The question of when, if ever, persons should be permitted to profit from information advantages in exchanges is not limited to insider trading. The problem has vexed philosophers, economists, and jurists for more than two thousand years. Chapter 6 prefaces the critical ethical and economic analysis of insider trading specifically by surveying the history of ideas pertaining to information asymmetries in commercial exchanges generally. Throughout history scholars and jurists have advocated rules ranging along the spectrum from the requirement of strict parity of information in all commercial exchanges (Cicero, some Scholastics, Pothier, and others) to the laissez-faire rule of caveat emptor (Chief Justice John Marshall in his opinion in *Laidlaw v. Organ*).[13] All sides of this debate have made regular appeals to the commonsense ethical values of good faith, equality, justice, fairness, autonomy, social welfare, the virtue of generosity, and the vice of greed. These ethical values have then been balanced against the need for economic efficiency and the practical necessities of trade. No single approach to the problem of information asymmetries in trade has won a consensus, leaving normative ambivalence to persist on the issue.

The strategy of this book is not to settle the debate over information asymmetries in commerce by presenting a unified ethical or economic theory as dispositive of the question. Chapter 7 argues that any such strategy would be futile. Rather, this book is pragmatic in its approach to the justification of legal reform. It considers the problem of insider trading from *all* of the evaluative standpoints identified in Chapter 6 (economics, morality, and virtue ethics) and looks to determine what reforms to the current insider trading regime in the United States will represent the proper balance among these important values. To this end, Chapter 7 offers critical introductions to the evaluative theories employed in subsequent chapters: economic and rational choice theory, the critical moral theories of consequentialism and deontology, and virtue ethics. In introducing these theories, the chapter also exposes some of their inherent limits as tools for legal reform.

Chapter 8 considers the economic impact of insider trading by summarizing some of the principal theoretical arguments and empirical data. The chapter considers potential economic harms such as insider trading's impact on counterparties, the problem of adverse selection, its effect on investor confidence and market liquidity, and potential perverse incentives such trading might create. The chapter also considers potential economic benefits, such as increased price accuracy, real-time information, decreased volatility, and its potential as an efficient form of corporate compensation. The theoretical results are mixed, and weak empirical evidence makes it difficult to ultimately quantify the net economic impact of insider trading with any certainty. Nevertheless, at a minimum, Chapter 8's study helps to identify the relevant stakeholders in the insider trading debate – those likely to be economically harmed, and those likely to benefit – even if the relative magnitude of the harms and benefits cannot be determined with certainty.

Even if it were proven with certainty that the practice of insider trading results in a net economic benefit to society, many would argue that it should nevertheless be

13 Laidlaw v. Organ, 15 U.S. 178 (1817).

legally proscribed because "it is just not right!" Chapter 9 analyzes the problem of insider trading from the critical standpoints of consequentialism and deontology, the principal other-regarding moral theories undergirding Western liberal jurisprudence. While it turns out that most forms of insider trading currently proscribed by law in the United States are indeed morally impermissible from the standpoints of both consequentialism and deontology, one such form of insider trading, "issuer-licensed insider trading," is morally permissible and should not therefore be the subject of civil or criminal sanctions.

Anticipating that the conclusion that there are no moral grounds for legally proscribing issuer-licensed insider trading will be controversial, Chapter 10 considers whether there may be an alternative ethical justification for its regulation in virtue theory. Moral conceptions of rights and duties do not exhaust the ethical landscape. The law is sometimes concerned with the type of people its institutions will create and foster. Many scholars and jurists have criticized the practice of insider trading as demonstrative of the vice of greed. But while it is true that some insider traders are greedy, it is argued that the criminalization of the practice would be drastically over- and under-inclusive as a prophylactic against that vice. Moreover, since issuer-licensed insider trading does not harm others, regulating it simply to prevent the character flaw of greed would violate one of the core presuppositions of Western liberal jurisprudence, John Stuart Mill's "Harm Principle." Any such justification for the criminalization of issuer-licensed insider trading would therefore be moralistic, placing it in the same class as the now-discredited legal proscriptions of sodomy, adultery, and same-sex marriage. But if the legal proscription of issuer-licensed insider trading cannot be justified on economic or ethical grounds, how can it be explained? Chapter 10 closes by offering some possible sociopsychological explanations of how the practice of criminalizing even issuer-licensed insider trading may have come about.

Chapter 11 draws upon the lessons and conclusions of previous chapters to outline a concrete plan for reform. It suggests the most promising tack is the adoption of an insider trading statute that improves upon the current common law regime in terms of scope and clarity. Incoherence in the current regime (between the SEC's favored equal-access theory on the one hand, and the courts' commitment to the fiduciary-cum-fraud model on the other) should be remedied by the adoption of a wrongful use theory of liability. The wrongful use model would limit the scope of insider trading liability to only that conduct that is economically harmful and morally wrong. Its scope of liability would be broader than the current regime's by capturing wrongful trading that does not involve the violation of fiduciary duties (for example, trading based on information acquired by outright theft), but it would be narrower than the current regime in that it would provide an express safe harbor for issuer-licensed insider trading (which, as the following chapters demonstrate, is not wrongful). The proposed reform would also improve clarity by offering statutory definitions of when information is "material" and "nonpublic," and a definition of when persons should be understood as trading "on the basis of" information. Trading in violation of a fiduciary duty of trust and confidence remains illegal under the proposed reform, but the duty of trust and confidence is expressly defined to improve ex ante certainty for traders. The proposed reform also expressly defines the requisite mental state for each element of insider trading liability. Finally, the proposed reform precludes derivative insider trading liability for controlling persons or employers who own the material nonpublic information that was traded upon, ensuring that innocent victims are never held liable for crimes perpetrated against them.

It is expected that the principal challenge to implementing the reforms outlined in Chapter 11 will be overcoming popular (and therefore political) resistance to liberalizing the regime to permit issuer-licensed insider trading. If the conclusions of the following chapters are credited, however, any such resistance is the product of a false consciousness that can be overcome by the open and honest discourse this book aims to spur.