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GREED, ENVY, AND THE CRIMINALIZATION OF INSIDER TRADING

John P. Anderson*

Abstract

In October 2011, a U.S. district court sentenced Raj Rajaratnam to eleven years in federal prison for insider trading. This is the longest sentence for insider trading in U.S. history, but it is significantly less than the nineteen to twenty-four-year term requested by the government. Such harsh prison terms (equal in some cases to those meted out for murder or rape) require sound justification in a liberal society. Yet jurists, politicians, and scholars have failed to offer a clear articulation of either the economic harm or the moral wrong committed by the insider trader.

This Article looks to fill this gap by offering a rigorous analysis of insider trading, its criminalization, and its punishment from multiple economic and moral perspectives. This analysis reveals that of the three forms of insider trading currently proscribed under section 10(b) of the Securities Exchange Act of 1934, two are economically harmful and morally impermissible, but, surprisingly, one is not—nonpromissory insider trading, where the insider trades on material nonpublic information while having made no promise or other commitment not to trade. Having reached this conclusion, this Article explores alternative justifications or explanations for criminalizing nonpromissory insider trading.

Virtue theory offers an alternative justification for the criminalization of nonpromissory insider trading, particularly the vice of greed. But while insider trading often reflects the vice of greed, a moralistic contempt for this character flaw cannot justify the criminalization of otherwise morally innocent conduct, as this would violate the firmly held, liberal harm principle famously articulated by John Stuart Mill.

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If the criminalization of nonpromissory insider trading cannot be justified, it must be explained. The sociopsychological theory of cognitive dissonance (as articulated by Dan Kahan and Eric Posner) is entertained as an explanation for how morally innocent conduct such as nonpromissory insider trading might first become criminalized and then later perceived to be immoral by a population. Under this theory, actors generally regarded as moral innocents may initially be targeted for punishment as scapegoats in the wake of a disastrous social event. Over time, to avoid cognitive dissonance between the belief that conduct is morally permissible and the act of punishing it, society simply drops its shared belief in the moral permissibility of the conduct.

This theory of cognitive dissonance fails to explain, however, why nonpromissory insider traders would be targeted as scapegoats to begin with. The moralistic contempt for the vice of greed in some insider traders offers one motivation, but the public's own vice of envy concerning the easy money made by insiders may offer another. Since neither motivation supplies a justification for criminalization in a liberal democracy, and since envy in particular has its own harmful effects on society, this Article concludes with the cautionary note that we should rethink our laws and reconsider our attitudes concerning nonpromissory insider trading.

I. INTRODUCTION

On October 13, 2011, a U.S. district court sentenced Raj Rajaratnam, general partner of Galleon Management, L.P., to eleven years in federal prison as part of the biggest insider trading[1] enforcement action in years.[2] This is the longest

[1] Economists and other scholars often use the term "insider trading" loosely to refer to any securities trading where one party enjoys an informational advantage over another based on material nonpublic information. *See, e.g.*, Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 733–34 (1988). Not all such trading need be performed by "insiders" as defined by the Exchange Act, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C.), nor is all such trading prohibited by law. In this Article, the term is used to refer generally to trading based on material nonpublic information that is proscribed by law under one of the accepted theories of Exchange Act section 10(b) liability. *See infra* Parts III.A–B. The different theories of insider-trading liability are, however, explicitly distinguished where appropriate.

[2] At least sixty-eight persons have been charged for their involvement in the Galleon insider-trading ring. Dominic Rushe, *Former Goldman Sachs Director Rajat Gupta Guilty of Leaking Insider Secrets*, GUARDIAN (Jun. 15, 2012, 1:51 PM), http://www.guardian.co.uk/business/2012/jun/15/rajat-gupta-guilty-leaking-insider. Sixty-two have been convicted or pled guilty. *Id.* None of those charged has been acquitted. *Id.* One of the most recent convictions (June 2012) was of Rajat Gupta, former Goldman Sachs director, for leaking insider secrets to Rajaratnam. *Id.* Gupta was sentenced to two years in prison (although prosecutors sought ten) and a $5 million fine. Michael Rothfeld & Dan Strumpf, *Gupta*

sentence for insider trading in U.S. history, yet it is significantly less than the nineteen to twenty-four-year term requested by the government. The stiff sentence for Rajaratnam reflects a trend of increasingly longer prison terms for insider trading. In fact, the median sentence for insider trading has almost tripled over the last two decades.[3]

The Rajaratnam case has reinvigorated the debate over the criminalization of insider trading, with some arguing that the stiff sentence the government requested is appropriate for a crime such as murder, but not for insider trading.[4] While the terrible evil committed by murderers is universally recognized across ethical perspectives, jurists, politicians, and scholars have failed to offer a clear articulation of the moral wrong or economic harm committed by insider traders.[5]

To further complicate the matter, despite the severe penalties imposed, neither Congress nor the U.S. Securities and Exchange Commission (SEC) has explicitly defined the crime of insider trading by statute or rule. Instead, they prefer to allow the law to develop on a case-by-case basis through the courts.[6] Absent an express statutory or regulatory definition, the SEC and federal prosecutors typically rely on three authorities in insider trading enforcement actions—the general prohibition found in section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") against "any manipulative or deceptive device or contrivance" in "connection with the purchase or sale of any security";[7] corresponding language in Exchange Act

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Gets Two Years for Leaking Inside Tips, WALL ST. J., Oct. 25, 2012, at A1, *available at* http://online.wsj.com/news/articles/SB10001424052970203897404578077050 403577468.

[3] *See* Chad Bray & Rob Barry, *Long Jail Terms on Rise*, WALL ST. J. (Oct. 13, 2011), at C.1, *available at* http://online.wsj.com/article/SB10001424052970204774604576626991955196026.html?mod=djemalertN.EWS (subscription required).

[4] *See, e.g.*, Jonathan Stempel, *Rajaratnam Sentencing May be a Fight to the Death*, REUTERS (Aug. 10, 2011, 2:32 PM), http://www.reuters.com/article/2011/08/10/us-galleon-rajaratnam-insidertrading-idUSTRE7795MV20110810.

[5] *See, e.g.*, Stuart P. Green & Matthew B. Kugler, *When Is It Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 447, 484 (2011).

[6] Indeed, during congressional hearings concerning the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984), some argued that the crime of insider trading should be defined with specificity, but Congress opted not to do so. *See* H.R. REP. NO. 98-355, at 13 (1983) (noting that while some had testified in favor of "specific language" to further define insider trading, the relevant committee believed "that the law with respect to insider trading [was] sufficiently well-developed at [that] time to provide adequate guidance"). Some scholars have argued this lack of a clearly defined statutory basis for insider trading raises concerns for the civil liberties of enforcement targets and for the constitutionality of the law itself. *See, e.g.*, Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 949 (1985).

[7] 15 U.S.C. § 78j(b) (2006).

Rule 10b-5;[8] and judicial and administrative precedent interpreting these provisions.[9]

Congress enacted the general antifraud provision of section 10(b) to "insure the maintenance of fair and honest markets."[10] But despite this clear moral motivation, little was said concerning the specific "evils" of insider trading in the 1933–1934 congressional hearings and final 1934 Senate Report of the Committee on Banking and Currency regarding the Exchange Act beyond conclusory statements characterizing insider trading as "vicious," a "flagrant betrayal," and "unscrupulous."[11] The lawmakers seemed to presume that the wrong in insider trading needed no explanation.[12] This attitude persists. As Jonathan Macey pointed out more than two decades ago, the "current scholarship that decries insider trading as 'unfair' completely lacks reasoned argument. Often those who brand insider trading as unfair do not even attempt to explain what insider trading is, much less *why* it is unfair."[13] Macey added that "[m]ost of the scholarship that attempts to label insider trading as unethical is based simply upon ideology, not ethical philosophy."[14] Unfortunately, the state of insider trading scholarship has not been

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[8] 17 C.F.R. § 240.10b-5 (2013).

[9] Though this Article focuses on the insider trading jurisprudence of section 10(b), it should be noted that enforcement actions based on facts surrounding insider trading are often brought under other statutory authority. For example, the Sarbanes Oxley Act of 2002 comprises a general anti-securities-fraud provision, whereby persons may be imprisoned up to twenty-five years for "knowingly" executing a "scheme or artifice" to "defraud any person" in connection with a security of a public company, or for obtaining "money or property" under "false or fraudulent pretenses" in "connection with the purchase or sale of any [such] security." 18 U.S.C. § 1348. Insider traders may also be prosecuted under section 17(a) of the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74, and SEC Rule 14e-3. 17 C.F.R. § 240.14e-3 (2013). In addition, prosecutors often rely on the general criminal provisions against mail and wire fraud. *See* 18 U.S.C. §§ 1341, 1343; Carpenter v. United States, 484 U.S. 19, 21 (1987) (convicting defendants under federal mail and wire fraud statutes in addition to section 10(b)). Even if an individual is not found guilty of fraud or deceit in connection with a securities trade, she may still be subject to criminal prosecution for a process offense such as knowingly and willfully making a materially false representation to the SEC or a federal agent during the course of a related investigation. For example, Martha Stewart was ultimately convicted under 18 U.S.C. § 1001.

[10] United States v. O'Hagan, 521 U.S. 642, 657 (1997) (quoting 15 U.S.C. § 78b); *see also* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847–48 (2d Cir. 1968) (explaining that Congress enacted section 10(b) to "to insure fairness in securities transactions generally").

[11] HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 8–10 (1966) (quoting S. REP. NO. 73-1455, at 55 (1934)).

[12] *See, e.g.*, Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 730 n.17, 731 n.19 (1988).

[13] Jonathan R. Macey, *Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 HARV. J.L. & PUB. POL'Y 785, 787 (1988) (emphasis in original); *see also* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 881 (1983) ("What is commonly left unsaid is how and why insider trading is unfair.").

[14] Macey, *supra* note 13, at 787.

significantly advanced with respect to these crucial ethical questions since Macey's observation.

The aim of this Article is to begin to fill this gap in the insider trading scholarship by offering a rigorous analysis of insider trading, its criminalization, and the severity of its punishment from multiple evaluative standpoints. Arguments for and against the criminalization of insider trading fall into one of two categories: they are either efficiency arguments, or they are arguments from principle. Efficiency arguments turn on the economic consequences of insider trading on counterparties and the broader market. Arguments from principle proceed from explicit moral premises to conclusions concerning the rightness or wrongness of the conduct of insider trading. Questions of efficiency and principle are best considered separately because one does not necessarily decide the other. For example, there may be good reasons to prohibit insider trading for moral reasons even if it is economically efficient.[15] Nevertheless, as will be demonstrated below, the questions of efficiency and principle are often overlapping. Economic considerations can impact moral outcomes, and, sometimes, moral attitudes will impact economic results. Thus, any comprehensive moral analysis of the practice of insider trading must take account of its economic impact while recognizing that such impact, great or small, does not necessarily decide the moral question.

With these considerations in mind, this Article proceeds as follows. Part II summarizes the current state of the scholarly debate concerning the economic impact of insider trading. While most economists now agree the direct impact of insider trading on counterparties is either nonexistent or indeterminable, the economic impact on the market as a whole remains hotly contested. These economic considerations (for and against insider trading) play an important role in the moral analysis of insider trading that follows.

Part III sets the stage for the moral analysis of the criminalization of insider trading by introducing the current state of the law, focusing on the "classical" and "misappropriation" theories of insider-trading liability pursuant to section 10(b) of the Exchange Act. To complete the tableau, Part III also summarizes different kinds of trading on material nonpublic information that do not appear to be currently criminalized (e.g., where material nonpublic information is gained by eavesdropping or luck, where the tipper does not benefit, etc.).

Part IV analyzes the currently criminalized forms of insider trading from consequentialist and deontological moral perspectives. The analysis begins, however, by assuming a legal regime that does not prohibit insider trading. This assumption ensures that the morality of insider trading can be tested independent of any social expectations arising solely from the fact that certain conduct is illegal. The morality of three types of insider trading are tested: promissory insider trading (where the insider promises or otherwise commits to the company not to trade in the company's shares), nonpromissory insider trading (where the insider makes no promises or commitments not to trade in the company's shares), and

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[15] *See, e.g.*, Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1439 (1967).

misappropriation trading (where the trader is not actually an insider but promises or otherwise commits to the source of material nonpublic information she will not trade on it). The analysis reveals that while both consequentialism and deontology condemn promissory and misappropriation insider trading, these theories fail to reveal anything morally impermissible in nonpromissory insider trading. The impact of these findings under the consequentialist and deontological theories of criminal punishment are then considered. The analysis concludes that these theories cannot justify the criminalization of nonpromissory insider trading. And while the other forms of insider trading should be criminalized, given the nature of the wrongs committed, we should revisit the severity of the punishments currently imposed.

Finally, having argued that nonpromissory insider trading is not immoral from the standpoints of either utilitarianism or deontology, the project would be incomplete without exploring why such trading is criminalized, and why it is almost uniformly regarded with contempt in our society. Part V addresses these questions. Given that Part IV limited the normative evaluation of nonpromissory insider trading to the other-regarding moral theories of utilitarianism and deontology, the possibility that society's contempt for all forms of insider trading can be traced to commonsense or *moralistic* attitudes (e.g., disgust at a vicious character trait) is explored. In particular, the vice of greed is considered. This Part concludes that while insider trading often reflects the vice of greed, a moralistic contempt for this character flaw cannot justify the criminalization of otherwise morally innocent conduct, as this would violate the firmly held, liberal "harm principle" famously articulated by John Stuart Mill.

If the criminalization of nonpromissory insider trading cannot be *justified*, it must be *explained*. The sociopsychological theory of cognitive dissonance (as articulated by Dan Kahan and Eric Posner) is entertained as an explanation for how morally innocent conduct, such as nonpromissory insider trading, might first become criminalized and then later perceived to be immoral by a population. Under the theory, moral innocents are targeted for punishment as scapegoats in the wake of a disastrous social event. Over time, society simply drops its shared belief that such conduct is morally permissible to avoid cognitive dissonance with the practice of punishing it.

The Article concludes by addressing the question of why nonpromissory insider traders would be targeted as scapegoats to begin with. The moralistic contempt for the vice of greed in all insider traders offers one motivation, but the public's own vice of envy concerning the easy money made by insiders offers another. Because neither motivation supplies a justification for criminalization in a liberal democracy, and because envy in particular has its own harmful effects on society, the Article closes with the cautionary note that we should rethink our laws and reconsider our attitudes concerning nonpromissory insider trading.

II. THE ECONOMIC IMPACT OF INSIDER TRADING

The scholarly debate concerning the economic impact of insider trading on individual traders and the market has been vigorous. Though this Article adds little to what has already been said by able economists (or more economically versed jurists) on the economic impact of insider trading, an understanding of the current state of this debate is crucial to the important ethical questions we address later.

A. Impact on Counterparties

Among the early rationales offered by the SEC and commentators in support of the prohibition of insider trading pursuant to section 10(b) is the protection of the counterparty to a securities trade from economic harm as a result of the insider's information advantage. As the SEC held in *In re Cady, Roberts & Co.*,[16] "If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of the information."[17]

The idea that any securities trade motivated by material nonpublic information must inevitably injure the counterparty appears uncontroversial at first blush. Absent the informational asymmetry, a counterparty would have certainly demanded either a higher or lower price, depending on whether she is selling or buying. Henry Manne and others, however, have argued that this proposition is not so straightforward. According to Manne, the relevant question is not what the counterparty to the transaction would do if she enjoyed informational parity, but "whether the person wanting to sell shares for exogenous reasons would behave differently before the information has been disclosed if insiders are or are not allowed to trade on the information."[18] Of course, every participant in the market

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[16] 40 S.E.C. 907 (1961).

[17] *Id.* at 914; *see also* Richard W. Jennings, *Henry G. Manne's Insider Trading & the Stock Market*, 55 CALIF. L. REV. 1229, 1232 (1967) (book review) ("[I]f the [insider information] had been promptly released the price would have risen more sharply and the investor would have had the benefit of the information."); Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 482 (1969) ("Since the information by itself would have caused an increase in the price of the stock, the shareholders who sold their stock to the insiders would have shared the benefits from the price increase with the continuing holders if the insider had not been buying."); William H. Painter, *Manne, Insider Trading and the Stock Market*, 35 GEO. WASH. L. REV. 146, 149 (1966) (book review) (asserting that the "intelligent long term investor" is "hurt badly" by insider trading because "he is deprived of information obviously relevant to whether he should sell"); Norman S. Poser, *Henry G. Manne's Insider Trading & the Stock Market*, 53 VA. L. REV. 753, 754 (1967) (book review) ("[T]he hypothetical investor would be unlikely to sell his shares if he possessed the same information the insiders enjoyed.").

[18] Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 934 (1985) [hereinafter *Property Rights*] (emphasis omitted); *see also* William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 898

would prefer complete information, but it only makes sense to claim insider trading itself results in an economic harm to the counterparty if it can be shown that the presence or absence of insider trading in the relevant security would have affected the counterparty's trade in some way.[19] Manne explains that there are both advantages and disadvantages to counterparties to insider trades. Using the example of a counterparty seller (where disclosure of the material nonpublic information will boost the stock price), "[t]he plus is the higher price received by those who would otherwise have sold at the stable, lower price, and the minus is the number of sales that now occur but which otherwise would not have occurred."[20]

Manne points out that those whose decisions to sell the security are motivated by price (generally short-swing traders, or speculators) are more likely to be harmed by an insider's trading than those whose trades in the security are strictly a function of time (generally long-term investors).[21] The speculator may be harmed by insider trading because such trading will gradually move the market price of the stock toward the price warranted by the information in advance of the public announcement. Since the speculator typically invests with a particular price point or profit amount in mind and sells when it is reached, she is harmed if her target price is short of the price the stock would naturally reach upon publication of the material nonpublic information. Investors, by contrast, sell strictly on considerations of timing (e.g., retirement, change of financial circumstances, or death). Though they would benefit from insider trading in this example (sold on the insider-created uptrend), they will be largely indifferent to whether the stock price changes dramatically or on a curve, so long as they continue to hold the stock.[22]

Thus, to assess whether the counterparty to a specific insider trade was harmed, one would want to know whether the counterparty was an investor or a speculator. But the realities of modern exchanges are such that the identity of the counterparty (or counterparties) to a transaction are virtually unknowable. Moreover, to conclude that the overall economic impact of insider buying on a particular security resulted in a net economic harm to all traders in the company's shares during the relevant period, it would be important to know whether the total volume of speculator selling due to the insider-generated price movement was greater than the volume of investor selling irrespective of price. And, adding another layer of complexity, to assess the net impact on all traders in shares of the

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(1987); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 552 (1970) [hereinafter *Law Professors*].

[19] *See* MANNE, *supra* note 11, at 93.

[20] *Id.* at 102.

[21] *See id.*

[22] *See id.* at 102, 107–09. The only risk to the investor is that his timing will be unfortunate. But, as Manne points out, because "the time required for full exploitation of information by insiders is generally quite short, the odds against any long-term investor's being hurt by an insider trading on undisclosed information is almost infinitesimally small." *Id.* at 110.

relevant equity, it would be important to know whether the volume of speculator selling was greater than the volume of speculator buying. Speculators buying at a particular price would enjoy a corresponding benefit from the insider-created curve.

Even those otherwise critical of Manne's positions concerning the economic impact of insider trading tend to admit he has the better of this argument. For example, Homer Kripke grudgingly admits that "[i]n a narrow sense, Manne has been right in saying that insider trading is a victimless crime (at least when done not face to face but anonymously in public markets)."[23] For, "no one knows whether those hurt by insider trading are more numerous than those hurt by trading before inside facts have impacted the market, so that they are price-takers taking a faulty price."[24] For these reasons, the harm-to-counterparty argument against insider trading has all but disappeared from legislative debates, court decisions, and scholarly treatment.

B. Impact on Investor Confidence and Market Liquidity

The promotion of investor confidence in the markets is among the most often-cited policy goals served by the criminalization of insider trading. As the Supreme Court noted in *United States v. O'Hagan*,[25] "Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."[26] The claim is that investors will stand on the sideline, refusing to participate because the perceived risks or costs of trading with insider traders are too great. The result will be that, in addition to the inefficiencies directly attributable to the practice of insider trading (the reason investors refuse to participate in the market), the decrease in participation will itself have the harmful consequence of reduced market liquidity and a higher cost of capital.

There are two claims implicit in this argument; one is psychological and one is economic. The psychological claim is that potential market participants' *mere perception* of risks or costs due to insider trading (warranted or not) will discourage them from participation in markets that fail to regulate it. This psychological claim is difficult to test, but the research that has been done finds little evidence of declines in market liquidity that corresponds to publicity about

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[23] *See* Kripke, *supra* note 6, at 953.

[24] *Id.* at 953–54 (citing Daniel Seligman, *An Economic Defense of Insider Trading*, FORTUNE, Sept. 5, 1983, at 47, 47–48).

[25] 521 U.S. 642 (1997).

[26] *Id.* at 658. The Supreme Court noted several sources making this argument, from legislative, *id.* (citing 45 Fed. Reg. 60412 (1980), to scholarly. *Id.* at 659 (citing Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979)). *See also* Kripke, *supra* note 6, at 954 (noting the "important public interest" in "confidence in the national securities markets").

insider trading in the market.[27] The more fundamental claim, however, is that investors' concerns of increased costs and risks to market participation where insider trading is permitted *are economically warranted*. The remainder of this section addresses this issue.

As this Article has explained, there is no measurable risk of direct harm to counterparties from insider trading, so that is not a concern that should discourage investors from market participation.[28] There are, however, other ways in which unregulated insider trading might harm the markets. For instance, some have argued that the practice of insider trading will have the net effect of delaying the release of material information to the public.[29] The logic is that insiders will need time to exploit their information (locate and free up capital, make trades, inform friends or associates, etc.) prior to its publication.[30] Certainly this incentive exists for insiders.

There is, however, dispute concerning the length of delay that can be expected based on these considerations. For example, even after a material fact is learned and undisputed within a company, preparation for public disclosure of that information is itself a time-consuming process: drafts of releases must be prepared and then reviewed by management and counsel. One would expect this period to offer insiders ample opportunity to trade on the information without affecting the timing of its release. For, in any event, it can be expected that the time necessary to make the arrangements for market transactions and informing others will be measured in minutes or hours rather than days. Moreover, insiders will also have every incentive to act quickly to beat other insiders to the punch and minimize the risk that the information will be leaked to the general public and become worthless.[31] More still, insiders will not just be motivated to act quickly, but once they have taken their positions, they will have every incentive to speed up the public release of the pertinent inside information to secure a profit that grows less certain with every passing minute the relevant information is not disclosed. So long as the information is not released, the insider runs the risk that an intervening event will counterbalance information traded on and thereby erode what would otherwise be a certain profit.[32] Finally, given that perfect enforcement of a ban on insider trading cannot be expected, such regulation may have the unintended consequence of itself delaying the release of information. By forcing insiders to

[27] *See, e.g.*, Robert E. Wagner, *Gordon Gekko to the Rescue?: Insider Trading as a Tool to Combat Accounting Fraud*, 79 U. CIN. L. REV. 973, 1000–05 (2011); Carney, *supra* note 18, at 896; Henry G. Manne, *The Case for Insider Trading*, WALL ST. J. (Mar. 17, 2003), at A.14 [hereinafter *The Case for Insider Trading*], *available at* http://online.wsj.com/article/0,,SB104786934891514900,00.html (subscription required); Manne, *Law Professors*, *supra* note 18, at 577.

[28] *See supra* Part II.A.

[29] *See, e.g.*, Mendelson, *supra* note 17, at 489; Schotland, *supra* note 15, at 1448–49.

[30] *See* Schotland, *supra* note 15, at 1448–49.

[31] *See, e.g.*, Manne, *Law Professors*, *supra* note 18, at 553.

[32] *See id.* at 568; *see also* Schotland, *supra* note 15, at 1448–49.

conspire and act covertly, such regulation may create its own incentive for insiders to push for a delay in release.[33]

Another efficiency-based argument offered for the regulation of insider trading rests on the concern that where insider trading is unchecked by regulation, market makers[34] will be forced to increase the spread between their bid and ask prices to protect against "adverse selection" by insiders.[35] The market maker's bid-ask spread (i.e., the difference in the prices at which she will buy and sell a given security) represents the "price for immediacy" and a function of "the cost of trading and the illiquidity of a market."[36] As one commentator explains, "The essence of the adverse selection model is that because of order imbalances and the difficulty of sustaining a liquid market only with matching, a liquidity provider has to transact with his own inventory and thus bears the risk of consistently buying 'high' from and selling 'low' to insiders."[37] Because market makers cannot distinguish between those who are trading on superior information from those who are not, the concern is that they will be forced to recoup these losses from the general trading public by increasing the bid-ask spread.[38] The increased spread therefore operates as a "tax" on all investors.[39] Moreover, an increased bid-ask spread will likely decrease liquidity for that security and thereby increase the company's cost of capital.[40] But while there is empirical data reflecting some

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[33] *See, e.g.*, Harold Demsetz, *Perfect Competition, Regulation, and the Stock Market*, *in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, 14 (Henry G. Manne ed., 1969) ("By increasing the cost of using the direct and obvious methods of capturing some of the value of this information, the SEC will encourage insiders to rely in greater degree on the less direct and more time-consuming methods.").

[34] Market makers are securities dealers that provide market liquidity by standing ready to step in and transact where buy and sell orders for a security fail to achieve equilibrium. For example, Barclays and Goldman Sachs & Co. are among the Designated Market Makers (or DMMs) for the New York Stock Exchange.

[35] For an excellent summary and comprehensive list of citations to the use of the adverse selection model by legal scholars and the SEC to point out the costs of insider trading as a justification for regulation, see Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 104–05 (2004).

[36] *Id.* at 89 (quoting, respectively, Harold Demsetz, *The Cost of Transacting*, 82 Q. J. ECON. 33, 35–36 (1968), and Hans R. Stoll, *Market Microstructure*, *in* 1A HANDBOOK OF THE ECONOMICS OF FINANCE 553, 562 (George Constantinides et al. eds., 2003)).

[37] *See id.* at 98 (citing Merton H. Miller & Charles W. Upton, *Strategies for Capital Market Structure and Regulation*, *in* MERTON H. MILLER, FINANCIAL INNOVATIONS AND MARKET VOLATILITY 127, 142 (1991)).

[38] *See id.* at 93, 96. Summarizing an article by Thomas E. Copeland and Dan Galai, Dolgopolov explains, "The spread is determined by the probability of informed trading, competition in market making, elasticity of uninformed trading with respect to the spread, trading volume, and the security's price volatility." Dolgopolov, *supra* note 35, at 96.

[39] *See* Manne, *The Case for Insider Trading*, *supra* note 27.

[40] *See* Dolgopolov, *supra* note 35, at 100–01.

correlation between the presences of insider trading and bid-ask spreads,[41] the significance of this evidence is disputed.[42] Others have observed that it does not matter to the market makers whether insider trading is regulated or not because if insiders could not trade, other market participants with superior information (analysts, brokers, etc.) would simply reap the rewards denied the insiders.[43] These and other considerations have driven many to conclude the assumption that insider trading undermines investor confidence may be unfounded.[44]

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[41] *See id.* at 93, 144–45. Dolgopolov cites to a number of empirical studies that concluded there is likely a correlation between information asymmetry in the market and increased bid-ask spreads. For example, one study found that intense insider trading is positively correlated to an increased bid-ask spread. George J. Benston & Robert L. Hagerman, *Determinants of Bid-Asked Spreads in the Over-the-Counter Market*, 1 J. FIN. ECON. 353, 362–63 (1974). Another concluded that the market maker's "losses must be recouped (at the expense of other investors) by setting a wide enough spread." Hans Stoll, *Dealer Inventory Behavior: An Empirical Investigation of Nasdaq Stocks*, 11 J. FIN. & QUANT. ANALYSIS 359, 367 (1976). And the list goes on. *See* Uptal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 76 (2002) (drawing on the theory of adverse selection to explain a purported correlation between the cost of equity and the enforcement of insider trading regulations in world markets); Dale Morse & Neal Ushman, *The Effect of Information Announcements on the Market Microstructure*, 58 ACCT. REV. 247, 257 (1983) (documenting widening spreads on days characterized by large price fluctuations and concluding that this could reflect attempts to protect against losses to those enjoying an advantage based on nonpublic information).

[42] *See* Dolgopolov, *supra* note 35, at 109. Dolgopolov notes that, surprisingly, market makers themselves have not been among those complaining of an adverse selection problem resulting from insider trading. *Id.* (noting that a spokesman for the Specialist Association of the NYSE said "insider trading isn't an issue for its members"). Dolgopolov observes, "This fact certainly casts doubt on the adverse selection argument's validity. This may be an indication that the magnitude of widening bid-ask spreads is negligible, or that market makers can somehow benefit from observing informed trading." *Id.* Moreover, Dolgopolov points out that

> market professionals, who, as frequent traders, could greatly benefit from lower transaction costs, and corporations, which could lower the cost of capital by increasing their shares' liquidity, similarly ignored the adverse selection model. This leaves the SEC as the only key player in the securities markets that consistently utiliz[es] the argument.

Id. at 109–10. As for the empirical studies reflecting a correlation, Dolgopolov cautions that there are also studies supporting an absence of any such correlation. *Id.* at 147; *see also* Manne, *The Case for Insider Trading*, *supra* note 27.

[43] *See, e.g.*, Carlton & Fischel, *supra* note 13, at 880 ("[T]he only effect a ban on insider trading might have is that those with better access to information, such as brokers, would reap some of the gains from inside information. While this may be inefficient because brokers can become informed only at a higher cost, the informed-uninformed trader problem remains.").

[44] *See, e.g.*, Wagner, *supra* note 27, at 1000–05.

C. Perverse Incentives—Moral Hazard

Another potential economic harm commonly attributed to the practice of insider trading is its creation of a perverse incentive by allowing insiders to profit on bad news.[45] The result is that, because trading profits can be made just as easily on bad news as they can on good news, management may become less concerned with its firm's profitability than with its market volatility. At the extreme, there is the moral hazard that management may actually attempt to create bad news to profit from it.

However, countervailing considerations dull the point of this potential harm. First, the fear insiders will intentionally create bad news to profit by selling the company's shares short ignores the myriad incentives against such conduct. For example, most insiders in a position to make money on information will want to maintain that position. Producing good news will provide opportunities for trading profits while at the same time securing that insider's place at the firm. By contrast, causing the firm to perform poorly is certain to put an insider's position at the firm at risk.[46] Additionally, insiders will rarely be in a position to single-handedly affect the price of the firm's shares. Important firm decisions are almost always made in teams. While it is easy to convince a team to make a good decision for the firm, it will be difficult to convince the team to approve a bad decision. Even if all the team members set out to collude in bringing the price down to secure trading profits, the benefits of whistleblowing to any one member (bonus, promotion, etc.) will almost always outweigh any benefits from continuing participation in the scheme.[47]

Finally, some have argued that, far from creating a moral hazard, in limited circumstances insider trading may offer an effective tool for disincentivizing accounting fraud in publicly traded companies.[48] For example, the personal wealth of CEOs and other senior executives are often tied directly to stock holdings in their company. When these executives acquire inside information they know will negatively affect the price of the stock, they may be forced to choose among the following unhappy alternatives: (1) hold on to their stock and release the information, resulting in personal financial ruin; (2) sell the stock and then release the information, immediately subjecting themselves to disgorgement, fines, and criminal liability for insider trading; or (3) issue fraudulent financials that may buy them time to fix the problem. The third option is often the only one that does not

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[45] *See, e.g.*, Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982); Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489–90 (1969) (reviewing HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966)); Schotland, *supra* note 15, at 1451.

[46] *See* MANNE, *supra* note 11, at 150.

[47] *See* Carlton & Fischel, *supra* note 13, at 873–74 (citing GEORGE STIGLER, THE ORGANIZATION OF INDUSTRY 39 (1968)).

[48] *See generally* Wagner, *supra* note 27 (arguing that "one way to help avoid future accounting scandals . . . would be the legalization of 'fraud-inhibiting insider trading'").

result in immediate ruin. This was the decision faced by Bernard Ebbers of WorldCom. The claim is that if Ebbers could have sold his WorldCom stock prior to announcing the company's earnings misses, his principal incentive for misrepresenting the company's financials would have been eliminated, and the company and its investors might have avoided collapse.[49]

D. Potential Social Benefits of Insider Trading

While considering the effects of insider adverse selection on bid-ask spreads, one study observes the "increase in efficiency [in pricing due to insider trading] may be worth the concomitant decrease in the liquidity of the market."[50] As this point reflects, any study evaluating regulation of conduct based on its potential economic harms must also consider any potential economic advantages. Some of the purported economic advantages of insider trading identified by scholars are summarized below.

1. Increased Accuracy of Price, Real-Time Information, and "Market-Smoothing" Effect

Most commentators have come to accept that insider trading pushes stock prices in the "correct" direction—i.e., to better reflect the company's true value in light of the nonpublic information.[51] It stands to reason that insiders are in the best position to assess the true value of their company and information affecting its price, and where insider trading is allowed, they can be expected to purchase or sell shares until the market reflects the correct price.[52] Moreover, insider trading allows a company insider's assessments of endogenous information to be reflected in its market price in real time on a daily basis without the costs, delays, and other

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[49] *See id.* at 976–82. Wagner does not advocate a blanket legalization of insider trading, only legalization of "fraud-inhibiting insider trading" of the type described here. *Id.* at 975–76.

[50] Dolgopolov, *supra* note 35, at 175 (quoting Lawrence R. Glosten, *Insider Trading, Liquidity, and the Role of the Monopolist Specialist*, 62 J. BUS. 211, 230 (1989)).

[51] *See, e.g.*, Carlton & Fischel, *supra* note 13, at 868 ("If insiders trade, the share price will move closer to what it would have been had the information been disclosed."); Manne, *Property Rights*, *supra* note 18, at 935 ("[N]o economist has ever denied . . . that insider trading will always push stock prices in the 'correct' direction."); Hsiu-Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 265 (1968) (arguing that insider trading tends to drive prices toward "intrinsic values" and consequently promotes a "fair price determination"). *But see* STEPHEN BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 136–44 (2d ed. 2007) (arguing that U.S. securities laws promote accurate market prices by requiring corporations to disclose nonpublic information).

[52] *See, e.g.*, Manne, *Law Professors*, *supra* note 18, at 569; Manne, *The Case for Insider Trading*, supra note 27.

disincentives associated with formal public releases and filings.[53] The result, some argue, is increased market efficiency and lower costs of capital.[54]

Such real-time reflection of information about a company through its stock price due to insider trading may also benefit the company's own management in its decision making.[55] For example, insiders often trade on nonpublic information concerning their company's problems (fraud or other issues) that have not yet been brought to the attention of management.[56] A corresponding change in stock price may issue a warning or "red flag" to management to identify and correct the problem before it gets worse. For this reason, some companies set up their own virtual or prediction markets to aid in their decision making.[57] The idea is that markets can organize and weigh the value of information better than individuals.[58] Indeed, some have argued that the value of insider trading to management in monitoring its company's stock price to predict current issues and future performance may help explain why shareholders and management rarely seek to restrain insider trading prior to its criminalization.[59]

Finally, the gentle sloping in price resulting from insider trading prior to the release of material nonpublic information arguably mitigates the market-shaking impact of radical price shifts that occur upon public release. This has been referred to as the "market smoothing" effect of insider trading.[60] In this way, insider trading may decrease volatility and serve as a stabilizing force that benefits all market participants.

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[53] Given the scrutiny to which disclosures are subject by analysts and regulators, they are made only rarely (when they cannot be avoided altogether) and usually contain a thoroughly watered down version of relevant facts. Insider trading, by contrast, allows a stock to reflect insiders' current assessment of uncertain situations on a day-to-day basis. *See, e.g.*, MANNE, *supra* note 11, at 149 (noting that insiders have an incentive to correct incorrect market price of their firms); Carlton & Fischel, *supra* note 13, at 868 ("Through insider trading, a firm can convey information it could not feasibly announce publicly because an announcement would destroy the value of the information, would be too expensive, not believable, or—owing to the uncertainty of the information—would subject the firm to massive damage liability if it turned out ex post to be incorrect."); Manne, *The Case for Insider Trading*, *supra* note 27 (arguing that "there are delays or uncertainties about what has to be disclosed" when insiders trade to make market price corrections).

[54] *See, e.g.*, Carlton & Fischel, *supra* note 13, at 866; Manne, *Law Professors*, *supra* note 18, at 565–66.

[55] *See* Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 174–83 (2005).

[56] *Id.* at 176.

[57] *Id.* at 181.

[58] *Id*.

[59] *Id.* at 174–77, 182.

[60] *See* Manne, *Law Professors*, *supra* note 18, at 574.

2. Efficient Compensation

Another potential economic benefit of insider trading is that it may serve as an attractive form of compensation for company employees that encourages innovation and entrepreneurship at little or no cost to the shareholders.[61] Insider trading's usefulness as a cost-effective mode of compensation has remained a central component of Manne's argument for the legalization of insider trading.[62] According to Manne, it is just a matter of "simple economics":

> If any service presently being purchased by the corporation is compensated more highly, more of that service will be offered. Valuable information is an economic good that can be substituted for other media in which the higher compensation can be paid. If the service performed is or can be one which gives access to valuable information, less of other forms of compensation must be paid in order to secure the same amount of the service.[63]

Dennis W. Carlton and Daniel R. Fischel argue insider trading is an efficient form of compensation based on the familiar Coase theorem.[64] They point out that the question of whether insider trading is beneficial to a firm can be answered by determining who values the property right to that information more, the firm's managers or the firm's investors.[65] Depending on the answer, the parties will "engage in a value-maximizing exchange by allocating the property right in information to its highest-valuing user."[66] Thus, if the practice of insider trading is inefficient, then both firm insiders and the firm's investors would profit by allocating the property right to inside information to the firm's investors.[67] The fact that firms do not seek (and historically have not sought) to eliminate insider trading "suggests that the explanation for the absence of such prohibitions is that they are inefficient . . . ."[68] Thus, again, more accurate pricing and increased

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[61] *See, e.g.*, Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, 14 Q. J. AUSTRIAN ECON. 3, 17–18 (2011).

[62] *See, e.g.*, *id.*; MANNE, *supra* note 11, at 155; Manne, *The Case for Insider Trading*, *supra* note 27. *But see*, BAINBRIDGE, *supra* note 51, at 144–47 (arguing that Manne's cost-effective compensation argument is flawed by the inherent limitation on the insider's ability to trade on that information, i.e. his wealth).

[63] Manne, *Law Professors*, *supra* note 18, at 579.

[64] Carlton & Fischel, *supra* note 13, at 861–66. *See generally* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (arguing that, without transaction costs, bargaining will lead to efficient economic outcomes of trade regardless of the initial allocation of property).

[65] Carlton & Fischel, *supra* note 13, at 863.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 865. The Authors add that "[i]t is not possible to argue that federal regulations have eliminated the incentives for firms to ban insider trading because such trading is still widespread and profitable." *Id.* at n.31; *see also* Carney, *supra* note 18, at 895–96 (stating

convergence of interest between management and shareholders may offer explanations for why firms have not sought to regulate insider trading.[69]

Finally, any objection to insider trading as a form of compensation because it is "secret"[70] or "covert"[71] can be overcome by requiring that corporations announce publicly any policies permitting insider trading.[72] And, in any event, the fundamental premise of this justification for insider trading is that it benefits shareholders and is therefore an arrangement they would, all things being equal, choose for themselves.[73] Indeed, a recent empirical study suggests that companies do in fact adjust their executive compensation based on insider trading policies.[74] For example, where companies offer "Rule 10b5-1 trading plans," their CEO compensation is on average 20% lower.[75]

III. STATE OF THE LAW: SECTION 10(b) INSIDER TRADING

Congress designed section 10(b) of the Exchange Act[76] as a "catchall" clause,[77] but the Supreme Court has held that "what it catches must be fraud."[78] Consequently, the violation of insider trading has been read into section 10(b) and SEC Rule 10b-5[79] as a form of common-law fraud or deception. Insider trading does not, however, fit neatly into the paradigm for common-law fraud. While an action based on common-law fraud typically requires an affirmative

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that while it is impossible to determine whether investors are driven from the market because others earn greater profits than they do, history suggests otherwise as there was little investor concern when arbitrageur Ivan Boesky collected "perhaps the largest identified insider trading profits of all time").

[69] *See* Carlton & Fischel, *supra* note 13, at 866–72; Manne, *supra* note 55, at 182.

[70] *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968).

[71] *See, e.g.*, MANNE, *supra* note 11, at 12. William Cary, Chairman of the SEC from 1961 to 1965 asserted, "The use of inside information by a director or other manager to trade in shares is the securing of additional compensation in a covert fashion, and should be condemned."

[72] *See, e.g.*, Manne, *Law Professors*, *supra* note 18, at 580–81 ("If the SEC were faithful to its stated philosophy, it would simply require every corporation to state whether or not insiders will be allowed to use information in the stock market or under what conditions this will be allowed. No more need be done.").

[73] Carlton & Fischel, *supra* note 13, at 882.

[74] *See* Wagner, *supra* note 27, at 994 (citing M. Todd Henderson, *Insider Trading and CEO Pay* 10 (Univ. of Chicago Law & Economics, Olin Working Paper No. 521, 2010), *available at* http://ssrn.com/abstract=1605170).

[75] *Id.* at 994–95. Such 10b5-1 trading plans allow insiders to set up preplanned trades that can later be cancelled. These plans are of course vulnerable to manipulation based on inside information. *See id.*

[76] Pub. L. No. 73-291, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C.).

[77] Chiarella v. United States, 445 U.S. 222, 234–35 (1980).

[78] *Id.* at 235.

[79] 17 C.F.R. § 240.10b-5 (2013).

misrepresentation that is reasonably and detrimentally relied upon by another party,[80] insider-trading cases typically turn on the silence, rather than the false statement, of the insider trader. Under the common law, however, silence will only constitute fraud where circumstances impose a duty on the person with the information advantage to disclose.[81] Thus, the key to identifying the limits of insider-trading liability lies in identifying the circumstances in which the courts will find such a duty to disclose.[82]

The SEC has consistently sought to expand the scope of the duty to disclose material nonpublic information under section 10(b) through its own rulemaking and enforcement actions based on liberal interpretations of judicial precedent. While lower courts are split—some ready to grant the SEC expanded enforcement power[83] and others ready to keep the SEC's ambitions in check[84]—the Supreme Court has sanctioned only two general theories under which a duty to disclose will exist: the "classical" theory and the "misappropriation" theory.[85]

A. The Classical Theory

The classical theory of insider-trading liability focuses on the duty to disclose arising from a relationship of trust and confidence that exists between the actual parties to the securities transaction.[86] Specifically, the classical theory finds liability in circumstances where corporate insiders seek to benefit by trading in shares of their own company based on material nonpublic information. Such trading breaches the corporate insider's fiduciary duties to the current or prospective shareholders of the corporation on the other side of the transaction.[87] A paradigm example of the classical theory of insider trading can be found in the

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[80] *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

[81] *See Chiarella*, 445 U.S. at 228 (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

[82] Of course, in the rare cases where the deception involves an affirmative misrepresentation, the duty-to-disclose requirement need not be met. *See, e.g.*, SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (holding that a hacker's gaining access to a computer database by misrepresenting his identity can be an affirmative deception where no independent duty to disclose is necessary to establish the requisite deception under section 10(b)).

[83] *See, e.g.*, United States v. Teicher, 987 F.2d 112, 120–21 (2d Cir. 1993) (expressing a willingness to adopt the SEC's preferred approach of stretching the scienter requirement to include trading while in knowing possession of material nonpublic information); *see also*, Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1340–48 (2009).

[84] *See, e.g.*, SEC v. Adler, 137 F.3d 1325, 1329–39 (11th Cir. 1998); United States v. Smith, 155 F.3d 1051, 1067–69 (9th Cir. 1998). Both *Adler* and *Smith* reject the SEC's preferred knowing possession test for insider trading liability in favor of the more restrictive use test.

[85] United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

[86] *See O'Hagan*, 521 U.S. at 652; *Chiarella*, 445 U.S. at 230.

[87] *See, e.g.*, *O'Hagan*, 521 U.S. at 652.

facts of *SEC v. Texas Gulf Sulphur*.[88] In that case, corporate insiders kept news of a rich mineral strike from the public while several insiders and their tippees purchased stock or calls in the company based on this information.[89] When the strike was finally announced, these insiders enjoyed significant profits from the resulting price jump.[90] The SEC brought and won an enforcement action against these insiders.[91]

Though *Texas Gulf Sulphur* offers a straightforward example of facts that would be captured under the classical theory of insider-trading liability today, the actual holding of that case (and other insider-trading cases coming before and some time after it) failed to articulate this theory and left the scope of insider-trading liability under section 10(b) unclear. In short, the *Texas Gulf Sulphur* decision left the impression that achieving parity of information in the marketplace was the goal of insider-trading regulation under section 10(b) and therefore *any* willful trading based on material nonpublic information (whether by an insider or not) was prohibited.[92] According to the SEC, anyone in possession of material nonpublic information was under an affirmative duty to either disclose that information to the counterparty to the transaction (ensuring parity of information) or abstain from trading altogether.[93]

The Supreme Court made its first *explicit* articulation of the classical theory of insider-trading liability in *Chiarella v. United States*,[94] where it rejected the general disclose or abstain rule in favor of a more limited reading of section 10(b).[95] In his capacity as a "markup man" for a financial printer, Chiarella learned the identities of takeover targets in advance of the market.[96] He then profited on this nonpublic information by purchasing shares in the target companies in advance of the public announcements.[97] The district court "permitted the jury to convict" Chiarella on a finding that "he willfully failed to inform sellers of [the] target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable."[98] While such a jury charge was consistent with the SEC's general disclose or abstain rule, the Supreme Court held it was not consistent with section 10(b) of the Exchange Act.[99]

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[88] 401 F.2d 833 (2d Cir. 1968) (en banc).

[89] *Id.* at 844.

[90] *Id.* at 847.

[91] *Id.* at 839–43.

[92] *See id.* at 848 (noting section 10(b) is based "on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information").

[93] *See, e.g.*, BAINBRIDGE, *supra* note 51, at 50–53.

[94] 445 U.S. 222 (1980).

[95] *Id.* at 231–35.

[96] *Id.* at 224.

[97] *Id.*

[98] *Id.* at 226.

[99] *Id.* at 234–35.

The *Chiarella* Court explained that the common-law duty to disclose arises only where there is a "fiduciary or other similar relation of trust and confidence" between the parties to a transaction.[100] Thus, application of the duty to disclose to insiders guarantees that those "who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[101] This is the core of the classical theory of section 10(b) insider-trading liability. In applying this classical theory to the facts of *Chiarella*, however, there are no grounds for liability under section 10(b). Chiarella was not a corporate insider of the target companies and received no material nonpublic information from them.[102] Thus, Chiarella violated no fiduciary or other similar duty of trust and confidence to the seller on the other side of his transactions.[103]

By articulating the classical theory of insider-trading liability in *Chiarella*, the Supreme Court expressly rejected the SEC's preferred theory of section 10(b) liability as enforcing "a system providing equal access to information necessary for reasoned and intelligent investment decisions,"[104] thereby ensuring certain buyers or sellers do not enjoy an "unfair advantage over less informed buyers and sellers."[105] According to the Court, the formulation of such a broad "parity-of-information rule," which "departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent."[106]

The government offered an alternative theory of section 10(b) liability in its brief to the Court in *Chiarella*, however, arguing that Chiarella "breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation."[107] The Court refused to decide whether this alternative to the classical theory had merit in *Chiarella* because such a theory was never presented to the jury in that case.[108] The Supreme Court did, however, take up this "misappropriation" theory of liability under section 10(b) almost two decades later in *United States v. O'Hagan*.[109]

B. The Misappropriation Theory

Under the section 10(b) misappropriation theory of liability, a person commits fraud "in connection with" a securities transaction when she misappropriates and

[100] *Id.* at 228.
[101] *Id.* at 230.
[102] *Id.* at 231.
[103] *Id.* at 228.
[104] *Id.* at 232.
[105] *Id.*
[106] *Id.* at 233.
[107] *Id.* at 235.
[108] *Id.* at 236.
[109] 521 U.S. 642 (1997).

trades on confidential information in breach of a fiduciary duty owed to the source of the information.[110] Instead of basing liability on a fiduciary relationship between a company insider and company shareholder, as under the classical theory, "the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information" by defrauding them "of the exclusive use of that information."[111] The Supreme Court first recognized the misappropriation theory in *O'Hagan*.

O'Hagan was partner at a law firm representing one company in the takeover of another.[112] He did not actually work on the takeover himself but learned of it from others in his firm.[113] Based on this nonpublic information, O'Hagan acquired positions in the target company and profited by more than $4.3 million when the takeover was finally announced.[114] The Court found O'Hagan satisfied the "deceptive device or contrivance" element of section 10(b) because he pretended loyalty as a fiduciary of the company that was making the tender offer to gain access to the confidential information.[115] The "in connection with the purchase or sale of any security" element of section 10(b) was met when O'Hagan acquired a position in the target company based on this information.[116]

Ultimately, the *O'Hagan* Court held that, insofar as the impact on the parties and the market is the same in both cases, it makes no sense to hold a lawyer like O'Hagan liable under section 10(b) if he works for a law firm representing the target of a takeover (as required under the classical theory) but not if he works for a law firm representing the bidder (which would be the result if the misappropriation theory of 10(b) liability were to be rejected).[117] The Court found that the language of section 10(b) does not require this odd result.[118] In fact, the Court pointed out that these two theories of section 10(b) liability are complementary:

> The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.[119]

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[110] *Id.* at 652.
[111] *Id.*
[112] *Id.* at 647.
[113] *Id.*
[114] *Id.* at 648.
[115] *Id.* at 653–54 (citing Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 119 (1984)).
[116] *Id.* at 656.
[117] *Id.* at 659.
[118] *Id.*
[119] *Id.* at 652–53.

C. When Trading on Material Nonpublic Information Appears to Be Legal Under Section 10(b)

There are many forms of willful securities trading based on material nonpublic information that are not captured by the classical or misappropriation theories and therefore appear to be free of section 10(b) liability. A brief exploration of these forms of insider trading will be helpful in two ways. First, it will offer additional resolution to this summary of the current approach to insider-trading enforcement under section 10(b) by identifying trading on material nonpublic information that does not appear to lie within its scope. Second, an understanding of situations where the law does not appear to criminalize trading on material nonpublic information will be instructive when, later in this Article, considerations of proportionality and arbitrariness are weighed in the moral evaluation of the appropriate punishment for insider trading.

1. Eavesdropping or Luck

Both the classical and misappropriation theories require the existence of a fiduciary or similar duty of trust and confidence. The classical theory requires that the party trading on material nonpublic information have a fiduciary-like relationship with the counterparty to the transaction, and the misappropriation theory requires that she have such a relationship to the source of the information. Consequently, courts have found no section 10(b) liability where a noninsider acquires material nonpublic information by sheer luck or by eavesdropping on the conversation of insiders.[120]

For example, Barry Switzer, the successful college and NFL football coach, overheard an insider privately discussing material nonpublic information concerning a publicly traded company while Switzer was sunbathing on the bleachers at his son's track meet. Switzer immediately acquired positions in the company and encouraged his friends to do the same.[121] When the information was finally announced, Switzer and his friends profited from a 16.5-point jump in the stock's price.[122]

Finding Switzer not liable for insider trading under section 10(b), the court quoted the Supreme Court's decision in *Dirks v. SEC*[123]:

> As we emphasized in *Chiarella*, mere possession of non-public information does not give rise to a duty to disclose or abstain; only a specific relationship does that. And we do not believe that the mere

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[120] It should be noted that although the Supreme Court has not specifically addressed this issue, the principal "eavesdropper" case, SEC v. Switzer, 590 F. Supp. 756, 761–63 (W.D. Okla. 1984), which is summarized below, relies on Supreme Court precedent in finding no section 10(b) liability.

[121] *Switzer*, 590 F. Supp. at 761–63.

[122] *See id.* at 759.

[123] 463 U.S. 646 (1983).

> receipt of information from an insider creates such a special relationship between the tippee and the corporation's shareholders.[124]

As the Supreme Court held in *Dirks*, tippee liability is derivative of the insider's duty and is only imposed where improperly conveyed by the insider:

> Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[125]

This is the two-part test for tippee liability under section 10(b). Because the insider in this case had no idea Switzer was eavesdropping on his private conversation, he did not breach a fiduciary duty to his stockholders, and therefore the court found no liability for the insider or Switzer. Section 10(b) simply "does not bar trading on the basis of information inadvertently revealed by an insider."[126] Switzer and his friends were allowed to keep and enjoy their profits from trading on this information advantage over the market.

2. Tipper Does Not Benefit

As the previous section demonstrates, tippee liability under section 10(b) only arises where both elements of the following two-part test are satisfied: First, the insider (or misappropriator) has breached a fiduciary or similar duty of trust or confidence in providing the information to the tippee with the intent of giving her an informational advantage in trading in the shares of the company. Second, the tippee knows or should have known there was such a breach by the tipper.[127] A crucial element of the first part of the test (i.e., the tipper liability from which the tippee liability derives) is that the tipper anticipates some benefit from sharing the information. As the Supreme Court held in *Dirks*, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders [by the tipper]. And absent a breach by the insider, there is no derivative breach [by the tippee]."[128]

Consider the facts of *SEC v. Maxwell*,[129] in which the SEC brought an enforcement action against insider David Maxwell and his barber of fifteen years,

[124] *Switzer*, 590 F. Supp. at 765 (quoting *Dirks*, 463 U.S. at 656 n.15) (internal quotation marks omitted).

[125] *Id.* (quoting *Dirks*, 463 U.S. at 660).

[126] *Id.* at 766.

[127] *See Dirks*, 463 U.S. at 660.

[128] *Id.* at 662; *see also Switzer*, 590 F. Supp. at 766 (finding the first element of the two-part *Dirks* test was not met because "Platt did not personally benefit, directly or indirectly, monetarily or otherwise from the inadvertent disclosure").

[129] 341 F. Supp. 2d 941 (S.D. Ohio 2004).

Elton Jehn. Jehn knew Maxwell worked for a publicly traded company and repeatedly asked him for inside information.[130] One day Maxwell came in for a haircut and told Jehn there was a "rumor" some buyers were "interested" in his company.[131] Maxwell was in charge of his company's due diligence efforts in advance of a merger.[132] He had been specifically instructed to keep information of the upcoming merger confidential and not to use the information for personal benefit.[133] Jehn proceeded to leverage everything he had to purchase positions in the company's stock. When the merger was announced, Jehn sold his position at a profit of $191,954.57.[134]

The court ruled there could be no section 10(b) liability for either Maxwell or Jehn because there was no evidence Maxwell benefited from the disclosure directly or indirectly. The court found that, given "the parties' relative stations in life, any reputational benefit to . . . Maxwell in the eyes of his barber is extremely unlikely to have translated into any meaningful future advantage."[135] There was also no evidence of a close friendship.[136] The relationship between the two was "no more than the relationship between a barber and his client."[137] Thus, as in *Switzer*, Jehn used material nonpublic information to gain an advantage over the market and was allowed to enjoy his near $200,000 in profits free of civil or criminal liability.[138]

3. *Announce Intent to Trade (Misappropriation)*

The Supreme Court explained in *O'Hagan* that full disclosure of intent to trade forecloses section 10(b) liability under the misappropriation theory:

> Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.[139]

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[130] *Id.* at 944.
[131] *Id.*
[132] *Id.* at 943.
[133] *Id.*
[134] *Id.* at 945.
[135] *Id.* at 948. Indeed Jehn argued, "Surely it cannot be claimed that the purpose of the alleged disclosure was so Mr. Maxwell would receive a better haircut, a better appointment slot, a better price?" *Id.* at 948 n.2. The court notes that *Dirks* "requires an intended benefit of at least some consequence." *Id.* at 948.
[136] *Id.*
[137] *Id.* at 947.
[138] *See id.* at 944–45.
[139] United States v. O'Hagan, 521 U.S. 642, 655 (1997).

In fact, as Justice Thomas pointed out in his *O'Hagan* dissent, "were the source expressly to authorize its agents to trade on the confidential information—as a perk or bonus perhaps—there would likewise be no § 10(b) violation."[140]

In *Carpenter v. United States*,[141] a *Wall Street Journal* (*Journal*) reporter was prosecuted for trading in advance of the publication of his daily column offering recommendations with respect to selected stocks.[142] The column was widely read and typically had an impact on its subject stocks' prices. The *Journal*'s official policy was that, prior to publication, the content of the column was the *Journal*'s confidential information.[143] In violation of this confidentiality requirement, the reporter entered into an arrangement with brokers whereby he would give them advance notice of the column's recommendations in exchange for a share of their trading profits.[144] Over a four-month period, the scheme netted the participants trading profits of $690,000. The reporter and other participants in the scheme were convicted under the federal mail and wire fraud statutes, as well as under the misappropriation theory of section 10(b) liability.[145]

Although the reporter deceived the *Journal* in *Carpenter*, at oral argument in *O'Hagan*, the government explained that if he "had gone to the Wall Street Journal and said, look, you know, you're not paying me very much. I'd like to make a little bit more money by buying stock, the stocks that are going to appear in my . . . column, and the . . . Journal said, that's fine, there would have been no deception of the . . . Journal" and therefore no section 10(b) liability.[146] The government's point was not that the *Journal*'s prohibition of such trading alone grounded the liability in *Carpenter*. In fact, the *Carpenter* Court explicitly rejected the argument that the reporter's "conduct in revealing prepublication information was no more than a violation of workplace rules."[147] The government in *O'Hagan* was emphasizing the fact that the key to the reporter's criminal liability in *Carpenter* was his sham promise not to reveal the *Journal*'s confidential information to support his scheme to share profits from trading on that information prior to

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[140] *Id*. at 689 (Thomas, J., concurring in the judgment in part and dissenting in part).

[141] 484 U.S. 19 (1987).

[142] *Id.* at 22–23.

[143] *Id.* at 23.

[144] *Id.*

[145] The *Carpenter* Court was evenly divided with respect to the convictions pursuant to the misappropriation theory of 10(b) liability. Thus, while the judgment was affirmed, the misappropriation theory of 10(b) liability did not become precedent until *O'Hagan*. *See id.* at 24.

[146] *O'Hagan*, 521 U.S. at 689 n.5. It remains an open question, however, whether this safe harbor in *O'Hagan* should be read to extend to the brazen misappropriator who discloses her intent to trade to the source and then trades over the source's vigorous objection. A straightforward reading of *O'Hagan* leaves one with the impression that the Court intended to leave such cases to be addressed by state law, not section 10(b). *See id.* at 655. But some courts have read the *O'Hagan* safe harbor to exclude the brazen misappropriator. *See, e.g.*, SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006); *see also* BAINBRIDGE, *supra* note 51, at 118–20.

[147] *Carpenter*, 484 U.S. at 27.

publication. Without this element of deception, there would be no section 10(b) liability.

4. Not Selling/Not Buying

Another circumstance in which a person appears to be able to gain an advantage over the market by making investment decisions based on material nonpublic information without incurring section 10(b) liability occurs when insiders or misappropriators refrain from buying or selling securities that they otherwise would have bought or sold. In such circumstances, there can be no section 10(b) liability because there has been no securities transaction—only an omission. Nevertheless, such decisions based on material nonpublic information would appear to have the same market effect. As Manne put it, "Refraining from selling stock that would otherwise have been sold has exactly the same economic effect on market price as a decision to buy the same number of shares."[148] Manne goes on:

> The upshot of all this is that people can make abnormal profits in the stock market simply by knowing when *not* to buy and when *not* to sell. They will not make as much perhaps as if they could trade on the information more efficiently, but nonetheless they will still make supra-competitive returns.[149]

Imagine a situation where an insider resolved on January 1 to build a 1,200-share position in her own company through a dollar-cost-averaging strategy. She called her broker and instructed him to purchase one hundred shares of her company's stock on the last business day of each month over the next year. On January 30, the insider learns nonpublic information that the SEC has initiated an investigation into her company for accounting fraud. Immediately upon learning this information, she calls her broker and instructs him to not make any purchases in her company's shares. This insider appears to have no section 10(b) exposure because refraining from making future purchases is not itself "the purchase or sale" of a security. The consequences for both the insider and the market are virtually the same as if she had shares in her company and sold them based on this information. Refraining from buying or selling may be the most common use of material nonpublic information by insiders, yet it does not appear to be criminalized, and it would be virtually impossible to police against if it were.[150]

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[148] Manne, *Property Rights*, *supra* note 18, at 938.
[149] *Id.* (emphasis in original).
[150] *See id.*

IV. IS INSIDER TRADING IMMORAL?

To recapitulate, under the current section 10(b) regime, trading on material nonpublic information will incur liability if (1) a corporate insider seeks to benefit by trading (or by tipping others who trade) in shares of her own company based on material nonpublic information (classical theory);[151] or (2) a person misappropriates material nonpublic information and, unbeknownst to the source, seeks to benefit by trading (or by tipping others who trade) on this information (misappropriation theory).[152]

In both cases the law locates the section 10(b) liability in a failure to disclose that violates a duty of trust and confidence (either to the shareholder or to the source of the information). It remains, however, to settle the question of whether this conduct proscribed by law is also morally wrong.

A. Assuming Insider Trading Is Not Illegal

To answer the moral question, one must first assume a legal regime that does not prohibit insider trading under either the classical or misappropriation theories. This allows the morality of insider trading to be tested independent of any contingent social expectations or attitudes arising solely from the recognition that it happens to be illegal. For example, a moral evaluation of the conduct of driving one's car on the left-hand side of the road would change dramatically depending on whether the law required people to drive on the right-hand side and set this expectation for other drivers. To drive on the left-hand side when the law requires you drive on the right needlessly puts other lives at risk. Here, the social expectation set by law makes otherwise innocent conduct morally wrong. Presuming an enforcement regime that does not already proscribe insider trading allows us to engage in honest evaluation of this conduct independent of such morally arbitrary considerations. After all, if part of our aim is to determine what moral reasons exist for criminalizing and punishing insider trading, it would be of little help to learn that, like driving on the left-hand side of the road, it is immoral simply because social practices and expectations have been built around its illegality.

The following moral evaluation focuses on three types of trading that are representative of the universe of conduct legally proscribed under the classical and misappropriation theories of section 10(b) liability, but which will be assumed legal for our purposes here:

> <u>Promissory insider trading</u>: Insider trades on material nonpublic information where the insider has promised—or otherwise undertaken pursuant to company policy—not to trade on such information.

[151] *See supra* Part III.A.
[152] *See supra* Part III.B.

(Promissory insider trading is currently proscribed under the current U.S. enforcement regime as a form of classical insider trading.)

Nonpromissory insider trading: Insider trades on material nonpublic information where the insider has made no promise—and there exists no company policy (express or implied)—not to trade on inside information. (It is presumed that the issuer's policy allowing insider trading is disclosed to the investing public.) (Nonpromissory insider trading is currently proscribed under the current U.S. enforcement regime as a form of classical insider trading.)

Misappropriation: Noninsider trades on material nonpublic information acquired without the source's knowledge and in violation of a promise (or otherwise-acquired commitment of trust or confidence) to the source.

B. Consequentialist Answer

Consequentialism identifies the rightness or wrongness of an act with the goodness or badness of its consequences. The exposition of any consequentialist moral theory comes in two parts: First, the theory must define the good—i.e., offer a criterion "for ranking overall states of affairs from best to worst from an impersonal standpoint" (giving equal weight to the interests of every person).[153] Second, once the good is defined, the theory holds that right action will simply be a matter of maximizing that good.[154] Thus, for consequentialists, the "good" is morally prior to the "right." Consequentialism is a simple and compelling theory: maximize good and minimize evil. Or, as the philosopher Samuel Scheffler puts it, the consequentialist's sole aim is "to make the world as good a place as possible."[155]

Although there are as many consequentialist moral theories as there are conceptions of what is good, utilitarianism, which defines the good in terms of happiness or preference satisfaction,[156] is by far the most prominent. We will therefore focus our consequentialist evaluation of the morality of insider trading in light of the demands of utilitarianism. Since the goal here is not to test the moral rightness or wrongness of a specific historical act of insider trading, but rather to determine whether there are moral reasons for the criminalization of three different

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[153] *Introduction* to CONSEQUENTIALISM AND ITS CRITICS 1, 1 (Samuel Scheffler ed., 1988).

[154] *Id.*

[155] *Id.*

[156] It should be noted that even within utilitarianism, there are hedonistic and nonhedonistic variants. Hedonistic variants identify the good with sensual pleasure, while nonhedonistic versions focus instead on the satisfaction of preferences. The term "satisfaction" is used here to capture either of these variants. *See* SAMUEL SCHEFFLER, THE REJECTION OF CONSEQUENTIALISM: A PHILOSOPHICAL INVESTIGATION OF THE CONSIDERATIONS UNDERLYING RIVAL MORAL CONCEPTIONS 3 n.4 (1982).

types of insider trading, the following analysis will apply the principle of rule utilitarianism, which judges the utility of regulating behavior as a rule.[157]

1. Utilitarianism and Promissory Insider Trading

In evaluating promissory insider trading from the standpoint of rule utilitarianism, one must answer the following question: would a world in which everyone generally follows the rule *not* to commit promissory insider trading be superior from the standpoint of utility to a world in which there is no such rule and insiders are free to break their promises and make such trades whenever it would benefit them? If the answer is yes, then promissory insider trading is immoral on rule utilitarian grounds.

The two principal features of promissory insider trading to be analyzed from the rule utilitarian standpoint are (1) the promise breaking, and (2) the utility of the trading itself. Certainly we can anticipate that regular promissory insider trading would undermine the practice of promise making in this corporate context. No one would expect employees to keep such promises, so the practice of demanding them would cease to exist. To measure the impact of this practice falling away, we must consider the interests companies seek to protect and promote via the promise not to trade on material nonpublic information. While it remains an open question as to whether companies and their shareholders *always* share an interest in not allowing their employees to insider trade,[158] there are certainly *some* contexts in which promises not to trade will be very important to the company. For example, in the context of merger negotiations, there is a risk that insider trading will drive the market price up and thereby scare off potential suitors. Consequently, where such interests are present, and promises not to trade are not honored or cannot be entered into, companies and their shareholders will be harmed. Moreover, regular promise breaking in this specific context might serve to weaken the socially beneficial practice of promise making in general.

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[157] There have, of course, been many articulations of rule utilitarianism. *See, e.g.*, John Stuart Mill, *Utilitarianism*, *in* UTILITARIANISM AND OTHER WRITINGS 270 (Mary Warnock ed., 1974) ("In the case of abstinences indeed—of things which people forbear to do from moral considerations, though the consequences in the particular case might be beneficial—it would be unworthy of an intelligent agent not to be consciously aware that the action is of a class which, if practiced generally, would be generally injurious, and that this is the ground of the obligation to abstain from it."); J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANISM FOR & AGAINST 9 (2008) ("Rule-utilitarianism is the view that the rightness or wrongness of an action is to be judged by the goodness and badness of the consequences of a rule that everyone should perform the action in like circumstances.").

[158] Few companies and their shareholders (if any) proscribed such trading prior to changes in the law that made insider trading on material nonpublic information illegal. *See, e.g.*, WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 35 (3d. ed. 2010); Manne, *supra* note 55, at 174–77.

Turning to the net utility of the trading itself, as noted above,[159] while most are prepared to agree there is no discernible harm to the counterparty in any one trade taken in isolation, there remains the concern that, where it is understood that insiders are regularly trading on material nonpublic information, market makers are likely to increase the bid-ask spread for stocks—thereby increasing the cost of capital and making the markets less efficient (though, again, this point is controversial[160]). This potential harm must be netted against the personal benefit of the promissory insider trades to the insiders. Of course the profits enjoyed from insider trading do not represent a net increase in wealth for society as whole, but they may represent a net increase in *utility*. Insiders will usually dramatically improve their own and their families' lives in one trade—whereas others who trade are unlikely to be made significantly better or worse off when considered together because those who happen to be trading in the direction of the insider will offset the effect of the counterparties. In other words, the insider's trade is likely to have disproportionately high utility by comparison to the combined direct effects on other traders. Finally, there is the potential benefit of increased market accuracy and smoothing that may result from the general practice of insider trading, as explained above.

Thus, taken together, we can expect several harms from the general practice of promissory insider trading: (1) the undermining of companies' abilities to prevent insiders from trading where such trading is harmful to their interests (e.g., in merger negotiation scenarios), (2) injury to the practice of promise making in general, and (3) potential increase in the cost of capital for companies resulting from the anticipated increase in the bid-ask spread (though, again, this harm is debated). In terms of benefits, we can expect only the disproportionately high utility the insiders will enjoy from their trade by comparison to other traders, and the potential for increased market accuracy and smoothing. Though it is difficult to be exact, it would appear the weight of harms for society resulting from the general practice of promissory insider trading (particularly the inability of companies to maintain insider trading discipline where the future of the company depends on it) would be greater than the benefits in terms of net utility.

2. *Utilitarianism and Nonpromissory Insider Trading*

How would the rule utilitarian regard nonpromissory insider trading? Predictably, the principal difference in the analysis of nonpromissory and promissory trading is the elimination of the foreseeable harms resulting from the promise breaking. Where the harm of promise breaking is set aside, the only disutilities to be factored are (1) the potential economic harm to actual counterparties by the insiders' trading (which will likely be little or nothing), and

[159] *See supra* Part II.

[160] As noted above, market makers understand that someone will always have an information advantage over them. *See supra* Part II.B. If it is not the insiders who beat the market, it will be the analysts.

(2) any potential decrease in market liquidity due to the increase in bid-ask spreads by market makers to account for insiders trading on superior information (which, again, may be little or nothing). Balanced against these considerations are (1) the disproportionate utility enjoyed by insiders who trade, (2) the potential for increased market accuracy and smoothing, and (3) the potential benefits to the company of an efficient method of compensation for its employees.[161] We can see that where there is no promise sought by the company (and therefore none broken by the insider), the balance of harms and benefits to society shifts in favor of nonpromissory insider trading—at least in number and probably also in weight. At a minimum, we can conclude the arguments for the net utility of such trading are at least as strong as those for net disutility. Thus, there appear to be no rule utilitarian grounds for the claim that nonpromissory insider trading is morally impermissible.

3. Utilitarianism and Misappropriation

The utilitarian's analysis of misappropriation trading parallels that of promissory insider trading and yields the same result. Considered from the standpoint of the rule utilitarian, the disutility resulting from the undermined interests of the source of the misappropriated information, the harm to the practice of promise making in this context and generally, and any possible increase in the bid-ask spread by market makers, will likely outweigh the foreseeable utility of the trades to the misappropriators and any increase in market accuracy and smoothing that may result from those trades.

4. Utilitarianism and Punishment of Insider Trading

For the utilitarian, the wrongness of a type of insider trading does not settle the question of whether acts of that type should be criminalized and subject to government sanction. Sanctions carry inherent disutility. First, there is the obvious disutility of the punishment for the punished (and the dependents, friends, and family of the punished). Second, there is the social cost of adjudicating and imposing the punishment. Finally, there are other social considerations such as general fear of being wrongly punished for the act. Thus, as Jeremy Bentham put it, "all punishment is . . . evil."[162] Consequently, the criminalization of a certain type of act will only be warranted for the utilitarian if (1) the general practice of committing such acts will result in net disutility; (2) criminalization and imposing sanctions will prevent such acts (whether by deterrence or incapacitation); (3) the gain in utility from the punishment's preventive effects is greater than the inherent disutility of the sanctions themselves; and (4) the punishment is no more painful

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[161] This was presumably not a benefit to be factored in the analysis of promissory insider trading because a company who seeks the promise of its employees not to trade can hardly count such trading as part of its compensation package to those employees.

[162] JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION 170 (Oxford 1879).

than necessary to achieve this result. In short, for the utilitarian, punishment "ought only to be admitted in as far as it promises to exclude some greater evil."[163]

With these principles in mind, the general practice of promissory insider and misappropriation trading would likely result in a net disutility for society as a whole. These practices are therefore at least candidates for criminalization under the utilitarian theory. If criminalization is to make sense with respect to these types of conduct, however, it must be the case that the punishment will deter, and that the net utility gained by the deterrence outweighs the disutility of the punishment and the costs of adjudicating and imposing it.

Some argue that the social costs of enforcing and adjudicating insider trading are particularly high because it is so difficult to detect and prove.[164] Moreover, despite the severe punishments imposed on those convicted, there is evidence that the criminalization of insider trading has had little deterrent effect. For example, the Financial Services Authority in the United Kingdom recently reported that its measure of "market cleanliness," the number of announcements concerning material information preceded by unusual price movements, has remained "between 25 and 30 per cent for a decade."[165] The figures in the United States are thought to be about the same.[166] In light of these facts, it will be particularly important for utilitarian lawmakers to scrutinize the social costs of the proscribed behavior—asking whether they are clear and significant enough to justify these challenges to enforcement. Whatever the answer, it is important to note that the analysis above found the disutility associated with both promissory and misappropriation trading focused principally on broken promises or other commitments (to the company and the source), and not significant harmful effects to counterparties or the market as a whole. With this in mind, we might wonder whether existing state criminal laws against theft or conversion would be more efficient enforcement mechanisms from the utilitarian standpoint. The additional costs associated with the extra layer of enforcement at the federal level may not be warranted given the nature of the harmful consequences. As the Supreme Court noted in *SEC v. Zanford*,[167] "Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[168]

While it is clear promissory and misappropriation trading are candidates for criminalization, our analysis above indicates that the criminalization of nonpromissory insider trading is unlikely to be justified on utilitarian grounds. Absent the disutility associated with the broken promise, there is the presumption that the companies that license such trading will benefit (either by better market pricing for the stock and/or as an efficient means of compensation); in addition,

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[163] *Id.*

[164] *See* Manne, *supra* note 55, at 184 n.62.

[165] Editorial, *Rajaratnam's Guilt and Market Justice*, FIN. TIMES (May 11, 2011, 11:05 PM), http://www.ft.com/intl/cms/s/0/964e92f6-7c01-11e0-9b16-00144feabdc0.html#axzz20NUnnKau (subscription required).

[166] *Id.*

[167] 535 U.S. 813 (2002).

[168] *Id.* at 822.

there is the utility of the trade to the trader. The only serious countervailing consideration was the potential for an increased bid-ask spread and therefore a greater cost of capital. But we have found the impact of this was speculative because, as market makers themselves will point out, someone will always have an information advantage over them—if it is not the insiders who beat the market, it will be the analysts. And, in any event, if companies deem the risk of an increased bid-ask spread significant, they can choose to demand a promise not to trade. Thus, given the criminalization of nonpromissory insider trading under the current section 10(b) regime, and that the severity of punishment for violations is equal to that for promissory insider and misappropriation trading, we must ask whether we have missed something, at least from the utilitarian perspective.

5. *Disutility of Perceived Unfairness*

It could be that our utilitarian analysis of nonpromissory insider trading is correct as far as it goes, but that utilitarianism just fails to give the correct answer. For example, it may be that what makes such trading wrong is not that it makes society worse off from the standpoint of the utility of its consequences, but that it is simply unfair—or that it fails to treat people with equal respect as moral agents. We will explore this question in the next section as we analyze insider trading from the standpoint of deontological theories. But the issue of fairness raises one further consideration to weigh in the utility calculus before we move on.

Regardless of whether nonpromissory insider trading actually turns out to be unfair, if it is generally perceived to be, this shared perception alone may be enough to undermine investor confidence in the market and therefore reduce participation (the economic harm addressed in Part II). Thus, shared attitudes that nonpromissory insider trading is unfair (justified or not) may be enough to reduce liquidity and increase the cost of capital. If so, this may be enough to make nonpromissory insider trading wrong from the standpoint of utilitarianism. We return to this issue below.

C. *Deontological Answer*

As the name suggests,[169] deontology is a duty-based theory. A central premise shared by deontological theories is that there are certain things we as moral agents must never do, regardless of the good consequences that may result. This premise is often expressed in the Latin phrase, *fiat justitia ruat caelum*, meaning "let justice be done though the heavens fall."[170] Thus, whereas consequentialism regards the good as prior to the right, the opposite is true for deontology. Immanuel Kant

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[169] The word "deontology" derives from the Greek words *deon* (duty) and *logos* (the science of). PETER ANGELES, DICTIONARY OF PHILOSOPHY 60 (1981).

[170] *See* 2 ENCYCLOPEDIA OF PHILOSOPHY 343 (Paul Edwards ed., 1972).

offered the first modern expression of such moral absolutism.[171] He is also the most important deontological theorist. This deontological analysis of insider trading will therefore proceed from Kant's (or at least Kantian) premises.

If morality does demand that we act in certain ways "though the heavens fall," then its command must be universal and absolute. Briefly, for Kant, to even consider the concept of such a command is to immediately apprehend what it contains. For, as universal, it contains no empirical and therefore contingent conditions (e.g., it cannot be motivated by our desires or caprice). There is "nothing remaining in it but the universality of law as such to which the maxim of the action should conform."[172] Consequently, there can be only one categorical imperative: "Act only according to that maxim by which you can at the same time will that it should become universal law."[173] In other words, one should never act on a reason everyone else could not also act on at the same time without contradiction. This is commonly referred to as the "Universal Law" formulation of Kant's categorical imperative. The Universal Law formulation makes explicit the commonsense appeal to fairness that is implicit in the familiar question, "What if everyone were to do that?" If everyone could not do it without destroying the good that is sought, then so acting would be to single oneself out as deserving of special treatment without justification.[174]

Kant offered other articulations of the categorical imperative as well. Insofar as persons have the capacity to exercise their practical reason to set their own ends without external influence, each of us is a law unto herself. This recognition yields the second, or "End-in-Oneself," formulation of the categorical imperative: "Act so that you treat humanity . . . always as an end and never as a means only."[175] In other words, never act in a way that uses others for purposes they themselves would reject. The End-in-Oneself formulation emphasizes that, as rational agents, we all enjoy absolute moral worth or dignity that cannot be purchased in the name of private expedience or social exigency. It should be noted that although Kant gave more than one version of the categorical imperative, he claimed they are "fundamentally only so many formulas of the very same law, and each of them unites the others in itself."[176] Presumably, the intended advantage of the different articulations was to facilitate apprehension of the moral law.

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[171] *See generally* IMMANUEL KANT, THE FOUNDATIONS OF THE METAPHYSICS OF MORALS AND WHAT IS ENLIGHTENMENT? (Lewis White Beck trans., 2d ed. 1990).

[172] *Id.* at 37–38.

[173] *Id.* at 38.

[174] Kant's Universal Law formulation of the categorical imperative is often identified with the "Golden Rule": do unto others as you would have done unto yourself. This is a mistake. For example, as it is typically articulated, the Golden Rule has no answer to the masochist who wants to torture others. *See, e.g.*, Fred Feldman, *Kantian Ethics*, *in* ETHICAL THEORY: CLASSICAL AND CONTEMPORARY READINGS 261, 266 (Louis P. Pojman ed., 1989).

[175] KANT, *supra* note 171, at 46.

[176] *Id.* at 53.

So how is the categorical imperative applied in practice? Consider one of Kant's own examples. If someone needs to borrow money but does not have the means of repayment, the categorical imperative would preclude her from borrowing the money on the promise of repayment. Applying the Universal Law formulation, if one considers whether the maxim "I will borrow money that I need without the intention to repay it" can be generalized to the form of a law, one will see it cannot without contradiction. As Kant explains,

> [T]he universality of a law which says that anyone who believes himself to be in need could promise what he pleased with the intention of not fulfilling it would make the promise itself and the end to be accomplished by it impossible; no one would believe what was promised to him but would only laugh at any such assertion as vain pretense.[177]

The universalization of such a maxim into law would involve a contradiction in that the conditions of the promise contained in the maxim would preclude the possibility of such a promise and could not therefore be willed consistently.

This maxim would also violate the End-in-Oneself formulation because making a false promise to induce a loan fails to respect the autonomy of the promisee. The obvious end of the promisee in the transaction is to receive repayment and interest, and he would never have agreed to enter into the loan if he knew there would be no repayment or interest. Consequently, to enter into such a loan agreement would be for the promisor to use the promisee, against his will, as a mere means of obtaining the promisor's end.

1. Categorical Imperative and Promissory Insider Trading

Again, promissory insider trading occurs when an insider trades on material nonpublic information and the insider has promised (expressly or impliedly) not to trade on such information. We have already seen that the practice of making a false promise is precluded by Kant's categorical imperative. Under the Universal Law formulation, we saw that the maxim on which this conduct is based cannot be universalized without contradiction (because the practice of promise making could not be sustained if everyone made false promises). In addition, it cannot be justified under the End-in-Oneself formulation because it necessarily treats the promisee (the company) solely as a means to an end (use of the company's material nonpublic information for trading profits) that the promisee has rejected. Thus, we need look no further than the false promise to identify promissory insider trading as morally impermissible under the categorical imperative.

[177] *Id.* at 39.

2. Categorical Imperative and Misappropriation

As was the case for our consequentialist analysis, there are few morally relevant distinctions between misappropriation trading and promissory insider trading from the deontological standpoint of the categorical imperative. In each case, the trading violates a promise or otherwise assumed commitment. For this reason alone, misappropriation trading will violate the categorical imperative for all the same reasons promissory insider trading does, and it is therefore morally impermissible.

3. Categorical Imperative and Nonpromissory Insider Trading

Turning now to the deontological analysis of nonpromissory insider trading, the Article considers whether the insider trades on material nonpublic information without having promised not to trade is morally permissible. Considered first under the Universal Law formulation, the relevant maxim is probably something like the following: "Whenever anyone can profit by trading in their company's shares based on material nonpublic information (and they have made no commitment not to), then she will so trade." Could this maxim be made universal law without contradiction? The answer appears to be yes.

Unlike the maxim for making false promises, there is nothing in the nonpromissory maxim that, if made law for everyone, would undermine the existence of companies or the markets such that universalization would involve a contradiction. Again, as noted above, there is the controversial claim that market makers will increase their bid-ask spreads where such conduct is made universal law, but (even supposing this worry is warranted) this falls well short of undermining corporations or the markets. Indeed, as we have discussed, when considered in light of other countervailing considerations (such as the increased market accuracy, decreased volatility, and more efficient corporate compensation), there is little reason to think the universalization of such trading would have a significant overall impact on companies or the markets at all. It appears, therefore, that nonpromissory insider trading satisfies the Universal Law formulation of the categorical imperative. Considering nonpromissory insider trading under the End-in-Oneself formulation can test this conclusion as well.

On the surface, there appears to be no problem for nonpromissory insider trading under the End-in-Oneself formulation because the counterparty to the trade will always be a willing and voluntary participant. The nonpromissory trader does not use the open-market counterparty as a mere means to the end of buying the stock at price "x" because the counterparty has her own reasons for wanting to sell at price "x". But there is more to the story: when the nonpromissory insider buys the stock, he does so *knowing* the stock is worth more than the sale price based on information the counterparty does not have. One might argue, however, that this must be a possibility the counterparty has considered and a risk she is prepared to take. For, except in the case of a seller who is trading solely to liquidate to cash, the counterparty herself is presumably betting that the stock will go down,

therefore believing that she has better information than the buyer.[178] Moreover, it is a well-settled legal and moral principle that parties may profit from information advantages acquired by legitimate means.[179] But something still seems to be missing from this story. The nonpromissory trader does more than just take advantage of superior research or skill; he knows the stock is worth more based on information to which *only an insider will have access*.

The fact that the counterparty has no access to the insider's information is where Stuart Green and others locate the moral wrong in insider trading.[180] According to Green, insider trading is wrong on deontological grounds because it amounts to cheating: an insider cheats the counterparty in a trade where the insider relies on information that, due to the regulatory regime in place, "was not even theoretically accessible to the public . . . ."[181] In other words, the wrong of insider trading can be summarized as follows: the insider trader "(1) *violates the SEC rule* that one must either disclose material non-public information or abstain from trading; and does so (2) with the intent *to obtain an advantage* over a second party with whom she is in a cooperative, rule-governed relationship."[182] Thus, for Green, cheating occurs when "an advantage is obtained unfairly, through rule-breaking."[183] But, as it stands, this explanation of why insider trading uses the counterparty as a mere means is question begging, at least if what we are interested in is the inherent morality of the trading itself. One is only cheating in Green's scenario if one *breaks the law* to take advantage of others' *compliance with the law*. In other words, insider trading only meets the definition of cheating if it is first illegal. The obvious problem with this explanation is that we are concerned with determining the morality of different forms of insider trading so we can intelligently judge whether they should be made illegal in the first place.

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[178] *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 256 (1988) (White, J., concurring in part and dissenting in part) (noting that many investors trade precisely because they are of the opinion that the stock price does not reflect the corporation's actual worth); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 852 n.6 (1992) ("Economists have long wondered about the efficiency paradox—that the existence of a high degree of efficiency depends on a critical mass of persons believing that it is worthwhile to try to beat the market, notwithstanding the model's teachings.").

[179] *See, e.g.*, Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 413–19 (1999) (arguing that neither the law nor respect for autonomy precludes one from profiting by failure to disclose superior information that was acquired by legitimate means such as research or skill).

[180] *See* STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE-COLLAR CRIME 235–40 (2006); Strudler & Orts, *supra* note 179, at 412 (arguing that any time someone trades on illegitimately acquired material nonpublic information, he cheats his counterparty who does not have equal access to that information); Patricia H. Werhane, *The Ethics of Insider Trading*, 8 J. BUS. ETHICS 841, 843 (1989) (identifying lack of "equal information" as a basis for categorizing insider trading as immoral).

[181] GREEN, *supra* note 180, at 241.

[182] *Id.* at 240 (emphasis added).

[183] *Id.* at 241.

As explained above, the moral analysis of insider trading offered here presumes a legal regime that does not ban any form of insider trading precisely to avoid such question begging. When it is posited that insider trading is not illegal, it is simply not true that it is "theoretically impossible" for the counterparty to have gained the information held by the nonpromissory trader through legitimate means. She could have sought out a position as an insider in the relevant company or perhaps acquired the information from another insider who was under no promissory obligation not to trade or tip. Admittedly, these alternatives may not be *easy* to accomplish, but they could be accomplished if trading on the inside information of this company were important enough to the counterparty. Again, information advantages are often difficult and costly to acquire, and this is one reason parties are typically allowed to profit from such advantages when the work is done and the costs incurred.[184] One may continue to object, however, that the nonpromissory insider is not benefiting from hard work or skill, but dumb luck; he happened to be in the right company at the right time. The information advantage is therefore not earned or deserved. Moreover, even if, assuming an equal opportunity employment regime, the counterparty had the same theoretical access to the nonpromissory insider trader's position in the company (and therefore enjoyed the same theoretical access to the inside information on which he traded), as things turned out in fact, the counterparty had no access to that information at the time of the transaction.

First, there may be some truth to the claim that the nonpromissory insider is benefiting from luck, but if the issuer and its shareholders[185] have elected to allow some of their insiders to trade on the company's material nonpublic information (as is the case with all nonpromissory insider trading), then, as noted above, they presumably have done so, at least in part, to reward or incentivize work on behalf of the company. So there is a nontrivial sense in which it can be assumed the nonpromissory insider has earned or deserves this information advantage. Moreover, even if the nonpromissory insider's information advantage is ultimately

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[184] *See, e.g.*, Alan Strudler, *Moral Complexity in the Law of Nondisclosure*, 45 UCLA L. REV. 337, 375 (1997) (arguing traders have a right to use information legitimately acquired by their labor to gain a market advantage).

[185] As noted above, it is presumed that the issuer's insider trading policy will be disclosed to the investing public. It is also assumed that issuers would only adopt such a policy if they could make a case that it will benefit the company (e.g., due to one or more of the purported economic benefits identified above). If shareholders objected to the policy, they would presumably force a change by voting their shares or voting with their feet (i.e., dumping their shares). This tacit consent by shareholders exposes the flaw in the "fraud on the investor" theory advanced by some. For example, Strudler and Orts argue that even nonpromissory insider trading is immoral on deontological grounds because by "competing with its own investors' rights to the company's profits when using information in which its investors have an interest, the firm or its authorized insiders would steal information that rightly belongs to its investors." Strudler & Orts, *supra* note 179, at 436. This argument gains no traction where, as in the case of nonpromissory insider trading, the shareholder has traded her right to the information in favor of the economic benefits to the company (and consequently its share price) advanced by insider trading.

attributable to dumb luck, there is no reason to think traditional principles of transactional law[186] or moral respect for the autonomy of the counterparty[187] would preclude him from profiting by such luck in a trade.

Second, as for the counterparty's lack of access to the nonpromissory insider's information at the time of the trade, such information asymmetry is common to the markets and not unique to insider trading. Imagine you are a ranch owner and learn from the owners of all the ranches adjacent to yours that, just yesterday, they entered into contracts to sell the mineral rights to their properties to Big Mining Company for three times the current market value. The next day, Big Mining Company contacts you and offers to buy your mineral rights for three times its current market value. You suspect something is up and refuse to sell. Sure enough, Big Mining comes back and offers you ten times the market value for your land. You are now convinced that Big Mining has made an important discovery in the area (though Big Mining has not told you this is the case, and there has been no public announcement of a discovery). Before even responding to their offer, you immediately leverage all your assets and buy Big Mining stock. One week later, the discovery is announced and the stock price doubles. This is certainly a case in which the person(s) from whom you purchased the shares on the open market would probably not have sold if they knew what you knew. Moreover, the counterparties to the transaction had absolutely no access to the information on which you traded. This is not the case of a diligent analyst figuring something out by creating a mosaic of publicly available information; even the most dialed-in analyst would not know what Big Mining offered *you* for your land (or even that an offer had been made).[188] By sheer luck, you received material nonpublic information through legitimate means and traded on it. Nevertheless, no one would allege that you treated your counterparty as mere means by this trading. This is because there is no deception. The counterparty trades on the assumption that other market participants may have better information. She does not object to this asymmetry, so long as the superior information was acquired by legitimate means; indeed, as noted above, the counterparty herself typically assumes she has better information when she makes her own trade. There is no morally relevant difference between the nonpromissory insider's trade and the one outlined in this paragraph. Market participants trade with the knowledge that legitimate information asymmetries exist, not despite it.

Thus, in the hypothetical market assumed in this section, where insider trading is not illegal, we may presume the counterparty to the nonpromissory insider trader is (or should be) aware of the possibility that other market participants have significant information advantages acquired without breach of

[186] *See, e.g.*, Laidlaw v. Organ, 15 U.S. 178, 193 (1817) (stating in dicta that failure to disclose news of a peace treaty with Britain that would dramatically affect the price of tobacco to the counterparty, even where the counterparty had no access to the news, would not constitute fraud). This case is discussed in more detail below.

[187] *See, e.g.*, Strudler & Orts, *supra* note 179, at 415–19.

[188] This example is adapted from one offered in BAINBRIDGE, *supra* note 51, at 47–49, 53.

duty or deceit. Such information advantages might be based on superior position (as in the case of the nonpromissory insider), on superior research or skill (e.g., one's counterparty could always be Warren Buffett), on dumb luck (as in the case of the rancher above), or on a little of all three. The counterparty to the nonpromissory insider knows all this and nevertheless sells her shares for her own reasons at the price she wanted to sell them at. The counterparty to the nonpromissory trade is, therefore, not cheated or treated unfairly where we assume such trading is not illegal; she is treated as an "end-in-herself" and not as a mere means.

4. Fairness and Nonpromissory Insider Trading

The deontological analysis of insider trading above allows us to place much that has been alleged concerning the "unfairness" of insider trading in perspective. As was noted above, Kant's categorical imperative offers an explicit theoretical articulation of our commonsense notion of fairness. John Rawls offers another.

Rawls labels the conception of justice he defends in *A Theory of Justice* as "justice as fairness." For Rawls, liberal political society is best conceived as a fair system of cooperation among free and equal persons.[189] Rawls claims his proposed conception of justice is fair because it is the conception members of the relevant society would choose for themselves in an initial choice position of equality, the "original position."[190] The original position generates fair principles by depriving the negotiators of any unfair bargaining advantages that turn on "the outcome of natural chance or the contingency of social circumstances."[191] It does this by placing the parties behind a "veil of ignorance." From behind this veil, parties are deprived of any knowledge of their class position, financial status, intelligence, work ethic, etc.[192] In short, for the purpose of this hypothetical negotiation, they do not know who they will be in the society for which they are choosing the principles of justice. The idea is that whatever principles rational and mutually disinterested parties would choose for themselves in this hypothetical negotiation will be fair because these parties have every incentive to select principles that are to everyone's mutual advantage. "Since all are similarly situated and no one is able to design principles to favor his particular condition, the principles of justice are the result of a fair agreement or bargain."[193]

Rawls's "justice as fairness" is only intended to apply to the basic structure of society (choice of a "political constitution and the main elements of the economic and social system"); it is *not* intended to apply to private associations or less comprehensive social cooperative arrangements or practices such as a securities

[189] JOHN RAWLS, A THEORY OF JUSTICE 11 (1971).

[190] *Id.* at 12.

[191] *Id.*

[192] Knowledge of these features of the parties' identities would result in an unfair advantage in choosing principles of justice because class, financial status, etc. are undeserved and are therefore morally arbitrary.

[193] RAWLS, *supra* note 189, at 12.

market.[194] Nevertheless, applying his familiar concept of the original position by analogy to the problem of insider trading may be elucidating. If we placed rational, mutually disinterested market participants behind a veil of ignorance that denied them knowledge of their respective roles in the market (e.g., investors, speculators, traders, analysts, market makers, firms)[195] and then asked them to choose between a system of market rules that were identical except one allowed nonpromissory insider trading and the other banned it, which would the parties choose? If we presume along with Rawls that the parties would choose the rule they can expect will be to the mutual advantage of all market participants, then, from what has been said, there is good reason to think the parties would either endorse the system permitting nonpromissory trading or would be entirely indifferent to it.

From the standpoint of Pareto superiority,[196] we have already noted that there is no reason to think the counterparty to a nonpromissory trade is made worse off by the transaction. Even if we consider the possibility that market makers may be forced to increase their bid-ask spreads in light of nonpromissory insider trading, this does not show that the market makers are worse off. By increasing the spread, they are just passing the increased risk along to other market participants. In light of the likely benefits to the other market participants, such as increased market accuracy, market smoothing, and more efficient corporate compensation, there is no reason to think those other market participants will decrease participation or be made worse off in the end. If they are made better off, then the system permitting nonpromissory trading will result in a Pareto-superior allocation of resources. Thus, given that the market participants behind our veil of ignorance would either select a system of market rules that allows for nonpromissory insider trading or be indifferent to it, such trading would be fair on this account.

Notice that the conclusion that there is nothing fundamentally unfair about nonpromissory insider trading (reached by applying both this Rawlsian method and Kant's method above) should put to rest the utilitarian concern raised above that public attitudes concerning the perceived unfairness of nonpromissory insider trading might be enough to undermine the markets.[197] If such attitudes exist, they are unfounded. Thus, the utilitarian must choose between correcting the false public perception (presumably at little or no cost in overall utility) or punishing

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[194] *Id.* at 7; *see also id.* at 8 ("These principles may not work for the rules and practices of private associations or for those of less comprehensive social groups.").

[195] Recognizing, of course, that market participants do not typically play only one role.

[196] In economic theory, there are several measures of efficiency. Among these are "Pareto optimality" and "Pareto superiority." Jules Coleman, *Efficiency, Utility, and Wealth Maximization*, *in* FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 10, 10 (Avery Wiener Katz ed., 2006). As Coleman has put it, "Resources are allocated in a Pareto-optimal fashion if and only if any further reallocation of them can enhance the welfare of one person only at the expense of another." *Id.* "An allocation of resources is Pareto superior," on the other hand, "to an alternative allocation if and only if no one is made worse off by the distribution and the welfare of at least one person is improved." *Id.*

[197] *See supra* Part IV.B.5.

such conduct (which always results in some disutility to those punished and those who are forced to forego fruitful opportunities for fear of being punished) to control market inefficiency that might otherwise be caused by the false perception. A true utilitarian would choose the first option.

5. Deontology and Punishment of Insider Trading

While the utilitarian justifications for punishment are entirely forward looking (concerned only with the socially useful consequences of punishment), the deontological theory of punishment, retributivism, is entirely backward looking. For the retributivist, the present justification for punishment turns exclusively on the nature and extent of the past wrongdoing for which the criminal is being punished. Punishment is a matter of ensuring justice both for the criminal and for society. Justice is done to the criminal by imposing the punishment she deserves for the crime (no more and no less). The difficult question for the retributivist, however, is how to determine what punishment will fit the severity of a given crime. The principle of *lex talionis*, or "an eye for an eye," is often relied upon as a measure of proportionality, though it has obvious limitations if applied literally. Beyond justice for the criminal, retributivism also seeks justice for society as a whole. For the retributivist, society is a cooperative enterprise to achieve order (among other things). The criminal takes an unfair advantage of this order. Consequently, the criminal owes a moral debt to society that must be repaid, and it is society's moral responsibility to demand repayment as much as it is the criminal's to offer it.[198] In short, for the retributivist, punishment is about righting wrongs by returning the moral scales to a balance for both the criminal and society by imposing a punishment that is neither more nor less severe than deserved given the wrong manifest in the criminal act.

We have seen that both promissory insider trading and misappropriation trading are immoral from the deontological perspective. The wrong is traced to the breach of trust between the trader and the source of the information. Either the insider broke her promise not to trade in the company's stock based on material nonpublic information, or the misappropriator deceived the source into giving access to material nonpublic information and then traded on it against the source's will.

Once it is settled that a wrong was done, the retributivist's next concern is determining a punishment that is neither more nor less severe than the crime. Disgorgement and some proportionate fine would seem in order. Indeed, depending on the circumstances, the lie or deception might even warrant incarceration, but the retributivist must be careful to maintain proportionality with the wrong. Lying and deceiving can be harmful, but recall that we were unable to

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[198] For this reason, Kant famously argued that even if we knew our society would end tomorrow, we would have a duty today to march out "the last murderer remaining" in prison and execute him. IMMANUEL KANT, THE METAPHYSICS OF MORALS 106 (Mary Gregor ed. & trans., Cambridge Univ. Press 1996).

pin down a clear harm to either the counterparty or the market as a whole. Thus, the magnitude of the wrong must be measured in relation to the importance of the promise to the company (in the case of the promissory insider trader) or the source (in the case of the misappropriator). Such analysis must be done on a case-by-case basis, but in light of what has been said above concerning the economic impact of insider trading, it would seem difficult to justify sentences in excess of twenty years that are now being sought by prosecutors.[199] As James Cox asks, "where are the bodies, where is the blood?"[200] Given the nature of the wrong, it rings false to claim promissory or misappropriation trading is a wrong of the same magnitude as murder or rape.

With respect to nonpromissory insider trading, of course, there is absolutely no retributivist justification for punishment. As we have seen, there is no wrong done, so there is no moral imbalance to correct.

D. Arbitrariness of Punishment Under the Current Insider Trading Regime

Even if one does not find the above moral analysis of insider trading compelling and remains convinced that nonpromissory insider trading is wrong, believing that the current trend of harsher sentencing is just and called for, one must still admit that our current legal regime is embarrassingly arbitrary and therefore comparatively unjust in its reach and application. For whatever one identifies as constituting the moral wrong in nonpromissory insider trading will also be present in trades based on material nonpublic information acquired by eavesdropping or luck or from insiders who do not themselves benefit by the trade, among other possible scenarios. Yet, as noted above, none of these latter forms of trading on material nonpublic information appear to be punishable under the current enforcement regime. In short, our current legal regime allows for Barry Switzer and Elton Jehn to enjoy their wild profits while striving to send others to jail for upwards of twenty years for conduct that is indistinguishable from a moral point of view.

V. GREED AND ENVY

The conclusion that nonpromissory insider trading is not inherently wrong from the standpoints of either utilitarianism or deontology (the two dominant moral theories informing Western liberal jurisprudence) is controversial and demands further exploration. Since such traders remain subject to criminal liability and stiff sentences under the current regime in the United States, alternative justifications must be considered. And if no alternative justification is available, then, at a minimum, the criminalization of this morally innocent conduct must be explained or accounted for. In what follows, such alternative justifications or explanations are explored.

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[199] *See, e.g.*, Rushe, *supra* note 2.

[200] Stempel, *supra* note 4.

First, the justification of the criminalization of nonpromissory insider trading as a matter of common sense is considered. Some may reject the utilitarian and deontological moral arguments above as flawed because they fail to cohere with commonly shared moral intuitions in our society. Since it is true that most share the commonsense opinion that all forms of insider trading currently proscribed by law are immoral,[201] this is a fair objection and should be addressed. The commonsense objection is addressed through critical analyses of historical examples, including one analysis offered by Marcus Tullius Cicero over two thousand years ago, and another offered by the U.S. Supreme Court two hundred years ago in the case *Laidlaw v. Organ*.[202] The juxtaposition of these examples exposes the commonsense intuition that there is something wrong with even nonpromissory insider trading as rooted, not in other-regarding moral considerations of justice or fairness, but rather in a concern over the flawed character it often reveals in the insider trader herself.

Second, having located the commonsense objection to nonpromissory insider trading as reflecting a flaw in the character of the trader, rather than in any unfair or unjust action inflicted on others, the nature and extent of this character flaw is considered. Greed is perhaps the most obvious vice reflected in nonpromissory insider trading. But if the sole objection to nonpromissory insider trading turns out to be an objection to the harm it does to the character of the trader (and not to some other person or persons), this is insufficient justification for its criminalization in a liberal society committed to Mill's harm principle.

Finally, having exhausted the most plausible justifications for the criminalization of nonpromissory insider trading, the final sections of this Article consider potential explanations for why criminal liability is imposed for this morally permissible conduct. The sociopsychological theory of cognitive dissonance articulated by Kahan and Posner in the context of insider trading is considered as offering one such explanation. According to the theory, individuals are sometimes punished for morally innocent conduct as scapegoats in the wake of a disastrous social event. Over time, society drops its shared belief that such conduct is innocent to avoid cognitive dissonance with the practice of punishing it. But why would nonpromissory insider traders be targeted as scapegoats in the first place? Envy over the easy money made by insider trading offers one explanation. To the extent the vice of envy does offer some explanation for the current criminalization of nonpromissory insider trading, however, it is concluded that the injustice of punishing this otherwise innocent conduct is only compounded by the socially harmful effects of envy identified by Rawls and others.

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[201] *See, e.g.*, Green & Kugler, *supra* note 5, at 484.

[202] 15 U.S. 178 (1817).

A. *Cicero,* Laidlaw*, and Common Sense*

In 44 BC, the last year of his life, Cicero authored *De Officiis* ("On Duties").[203] The treatise was written in the form of a letter to his son offering guidance on right living. To address the question of whether there is ever a conflict between expedience and morality, Cicero offers the following example:

> Suppose . . . a time of dearth and famine at Rhodes, with provisions at fabulous prices; and suppose that an honest man has imported a large cargo of grain from Alexandria and that to his certain knowledge also several other importers have set sail from Alexandria, and that on the voyage he has sighted their vessels laden with grain and bound for Rhodes; is he to report the fact to the Rhodians or is he to keep his own counsel and sell his own stock at the highest market price?[204]

Cicero notes that two "profound" Stoic philosophers, Diogenese and Antipater, disagreed on the answer. Antipater argued the grain dealer must disclose "all the facts" to ensure the buyer is not "uninformed of any detail that the [dealer] knows."[205] After all, "it is [one's] duty to consider the interests of [one's] fellow men and to serve society . . . ."[206] Diogenese countered that the grain dealer has every right to try to get the highest price the market will allow for them, so long as he makes no express misrepresentations and does not affirmatively conceal the truth.[207] The dealer may say, "I have imported my stock . . . I have offered it for sale; I sell at a price no higher than my competitors—perhaps even lower, when the market is overstocked. Who is wronged?"[208] Diogenese continues, explaining that if the moral demand that we consider the interests of others requires that we level all advantages that are acquired without wrong, then "we should not sell anything at all, but freely give everything away" until all inequalities are eliminated.[209] Ultimately, Cicero sides with Antipater and disclosure, though he offers little in the way of justification.[210] According to Cicero, the grain dealer should disclose because he would be no "straightforward or upright" man if he did not.[211]

Almost two thousand years later, the U.S. Supreme Court was confronted by similar facts in *Laidlaw v. Organ*.[212] The British blockade of the Port of New Orleans during the War of 1812 had the effect of depressing tobacco prices in the

[203] CICERO, DE OFFICIIS (Walter Miller trans., Harvard Univ. Press 1975) (44 B.C.E).
[204] *Id.* at 319.
[205] *Id.* at 319–21.
[206] *Id.* at 321.
[207] *Id.*
[208] *Id.*
[209] *Id.* at 323.
[210] *See id*. at 325–27.
[211] *Id.* at 327.
[212] 15 U.S. 178 (1817).

United States.[213] A letter containing news of the signing of the Treaty of Ghent, which ended the war and lifted the blockade, arrived in New Orleans on the evening of February 18, 1815.[214] Organ learned of this news before it was to be made public the following day.[215] Early the next morning, Organ contacted Laidlaw & Co. and offered to buy over 100,000 pounds of tobacco at the still-depressed market price.[216] Laidlaw's agent specifically asked Organ whether there was any news that might affect the price.[217] The record reflects that Organ did not respond.[218] Nevertheless, the parties concluded the contract.[219] Hours later, when news of the treaty spread, the price of tobacco jumped 30%–50%, and Laidlaw sought to rescind the contract.[220]

Laidlaw argued that "good faith not only forbids the assertion of a falsehood, but also all reservation concerning that which the person with whom we contract has an interest in knowing, touching the thing which is the object of the contract."[221] This is because "equity and justice, in these contracts, consists in equality."[222] The "moment the one acquires a knowledge of this object superior to the other, he has an advantage over the other in the contracting . . . and, consequently, equality is no longer found in the contract."[223]

Organ countered that the only issue is "whether the sale was invalid because the vendee did not communicate information which he received precisely as the vendor *might* have got it had he been equally diligent or equally fortunate[.]"[224] There was "no circumvention or manoeuvre practised by the vendee . . . ."[225] Organ's counsel concluded: "It is a romantic equality that is contended for on the other side. Parties never can be precisely equal in knowledge, either of facts or of the inferences from such facts . . . ."[226]

The Court, led by Chief Justice Marshall, sided with Organ, holding that disclosure of "intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee" is not required.[227] The Court reasoned that it would be "difficult to circumscribe" a rule requiring full disclosure in all cases of information

[213] JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 9.20, at 302 (6th ed. 2009).
[214] *Laidlaw*, 15 U.S. at 182–83.
[215] *Id*. at 183.
[216] *Id*.
[217] *Id*. at 183, 188–89.
[218] *Id*. at 189.
[219] *Id.* at 183.
[220] *Id*.
[221] *Id.* at 185 note c.
[222] *Id.*
[223] *Id.*
[224] *Id.* at 193 (emphasis in original).
[225] *Id.*
[226] *Id.* at 193–94.
[227] *Id.* at 195.

asymmetry.[228] To this day, *Laidlaw* is generally regarded as good law and is often cited for the general proposition that there is *ceteris peribus* no duty to disclose in a bargaining transaction.[229]

Randy Barnett defends the rule in *Laidlaw* as just and fair.[230] Barnett explains that even if Organ's silence in response to Laidlaw's inquiry concerning news that might affect the price of tobacco was misleading, Organ did not breach a duty because Laidlaw had no right to ask the question.[231] Imagine a commodities market in which every trader asked her counterparty whether she was in possession of any information that might affect the future supply or demand of the thing traded.[232] According to Barnett, "[E]ntitlement to a truthful answer . . . would virtually eliminate the institution within which both buyer and seller are operating."[233] To put it in Kantian terms, such a rule could not survive its universalization. Consequently, such questions should not be asked. Laidlaw's was like the question, "Would you be willing to pay more?" When one's counterparty asks such questions in the context of negotiations, it would be both naive and unfair to expect a truthful response.[234]

Nevertheless, the conflicting conclusions reached by Cicero and Chief Justice Marshall point to a commonsense ethical tension to which these facts give rise. As one commentator noted, "If [the facts of *Laidlaw*] were given to the normal person, as an abstract question, he would probably say that the buyer's conduct was unethical; on the other hand, if the same individual were given the opportunity the buyer had . . . he would do precisely the same thing."[235]

We recognize that nondisclosure of these facts may fall short of conduct expected of saints or other ethical paragons, but at the same time we are not comfortable demanding such disclosure of others or ourselves. It is the same distinction we draw between the Good Samaritan and everyone else. We shed praise on the Good Samaritan because in going out of her way to provide aid to others in need (sometimes at great expense), she displays a superior ethical character and virtue. We also recognize that those who fall short of the Good Samaritan's example have room for ethical improvement. Nevertheless, we are not prepared to recognize an absolute duty to always behave as the Good Samaritan

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[228] *Id.*

[229] PERILLO, *supra* note 213, § 9.20, at 302. Indeed, though the *Chiarella* Court did not cite to *Laidlaw*, its rule no doubt informed the Court's decision to reject the SEC's interpretation of section 10(b) as imposing a general duty to disclose to ensure parity of information. *See* Chiarella v. United States, 445 U.S. 222, 233–35 (1980).

[230] *See* Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J.L. & PUB. POL'Y 783, 799 (1992).

[231] *Id.*

[232] *Id.*

[233] *Id.*

[234] *Id.* at 800.

[235] PERILLO, *supra* note 229, § 9.20, at 302 (quoting W. Paige Keeton, *Fraud—Concealment and Nondisclosure*, 15 TEX. L. REV. 1, 32 (1936)).

would. This distinction is important: it represents the boundary between the demands of justice and fairness (what is morally required of us in our interactions with others) and supererogation (what we aspire to in our private pursuits of self-perfection).

There is a reason we distinguish the notion of duty from supererogation. It makes sense to say we have done our duty. But supererogation will always ask more of us. There is always more we can do to improve our characters, to become better people. The task of self-perfection is never complete. It therefore makes no sense to recognize supererogation as anything more than aspirational. Recognizing this divide between moral duty and supererogation allows us to reconcile Cicero and Chief Justice Marshall. As Barnett argues, the rule in *Laidlaw* recognizes that Organ violated no duty (did no injustice) in failing to disclose his information advantage.[236] But remember that Cicero wrote *De Officiis* to offer guidance for his son on how to be the best among men. It should come as no surprise then that Cicero would expect his son to aspire to do more than what is minimally required. He would rather his son earn a reputation for generosity than be wealthy; though the grain dealer would commit no injustice by failing to disclose, he would display a generous character if he did disclose. There is room for both Chief Justice Marshall and Cicero to be correct.

But what does any of this have to do with the subject of this Article? It is expected that the conclusion that nonpromissory insider trading does *not* violate a moral duty will meet some resistance from the standpoint of common sense. Many will complain, "It just seems wrong!" Though there are asymmetries, considering the nonpromissory insider trader alongside *Laidlaw's* Organ and Cicero's grain dealer helps to flesh out a possible source of this commonsense objection. Just as there is room for Chief Justice Marshall to find Organ violated no duty and at the same time for Cicero to find fault in the character of the grain dealer, there is also room for one to find the conduct of the nonpromissory insider trader violates no moral duty but nevertheless betrays an ethically flawed character. This concern is addressed in the following section.

B. Greed and Insider Trading

The normative evaluation of nonpromissory insider trading in Part IV was limited to the other-regarding theories of right and wrong manifest in utilitarianism and deontology, the two principal moral theories drawn upon in Western liberal jurisprudence. But it is possible our society's contempt for all forms of insider trading can be traced (at least in part) to moralism rather than morality. In other words, it may be traced to a shared societal disgust for the vicious character trait it reflects in the trader herself, rather than to some harm or injustice done to others. For example, one plausible explanation for our society's general contempt for insider trading is that it often reflects the vice of greed in such traders.

[236] Barnett, *supra* note 230, at 799.

For Aristotle, the vice of greed is contrary to the virtue of generosity. Generosity is the "mean concerned with the giving and the taking of wealth."[237] The generous person is one who will "both give and spend the right amount for the right purposes . . . and do this with pleasure."[238] He does not "honour wealth" for its own sake, but nevertheless acquires it "for the sake of giving."[239] By contrast, the greedy are "shameful love[rs] of gain" who "go to excess in taking, by taking anything from any source."[240] In their pursuit of wealth for its own sake, they are prepared to go to "great efforts and put up with reproaches."[241]

There is no question the facts of many insider-trading cases reflect the grasping smallness of character Aristotle had in mind when he defined the vice of greed. The case law is replete with examples (some summarized above) of small-time insider traders who desperately leverage all their assets to take advantage of their information advantage. It is just as common to find examples of big-time Wall Street players who make vast sums in the tens of millions on insider trading. But while acts of greed are always harmful to the actor's character, they need not be harmful to others. In fact, greedy acts will typically only directly harm others where they are also unjust or unfair.

We have, however, already considered and rejected the argument that nonpromissory insider trading is unjust or unfair. Thus, if such conduct is regarded as wrong strictly because it reflects the character flaw of greed, then we must admit it is not an other-regarding wrong (i.e., wrong because it harms others) but rather a self-regarding wrong (e.g., wrong because it undermines the actor's moral character).

There are two points to be made here. First, though nonpromissory insider trading may sometimes reflect the vice of greed, it need not always do so. As noted above, the generous person may also seek gain, if only to have more to give.[242] Here the motives of the nonpromissory trader must be explored, but we can certainly imagine a situation where the insider trades based on generous motives, e.g., to pay for his friend's kidney transplant operation. Second, even if a good argument could be made that allowing even nonpromissory trading will tempt citizens to the moral flaw of greed, this is not sufficient justification for its

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[237] ARISTOTLE, THE NICOMACHEAN ETHICS 89 (Terence Irwin trans., 1985).

[238] *Id.*

[239] *Id.*

[240] *Id.* at 92.

[241] *Id.* at 93.

[242] Indeed Rajat Gupta submitted evidence of his extensive philanthropy and leadership in global humanitarian causes in support of a more lenient sentence for his insider-trading conviction. Peter Lattman, *Push for Leniency as an Ex-Goldman Director Faces Sentencing*, N.Y. TIMES (Oct. 17, 2012, 7:03 PM), http://dealbook.nytimes.com/2012/10/17/in-sentencing-memos-two-views-of-gupta/. Over 400 letters describing Gupta's charitable work were submitted from the likes of Kofi Annan and Bill Gates. *Id.* Gupta even pleaded with the court to sentence him with probation and an order to serve in Rwanda, working with "rural districts to ensure that the needs to end H.I.V., malaria, extreme poverty and food security are implemented." *Id.*

criminalization. The justification for criminalization here would be paternalistic and moralistic in nature. A longstanding tenet of liberal justice and jurisprudence is that the coercive power of the state should not be exercised for such purposes. This constraint on the legitimate use of the state's coercive power is best expressed in Mill's harm principle: "[T]he only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant."[243]

Moreover, even if moral contempt for greed were relied upon to justify the criminalization of nonpromissory insider trading, the current state of the law would be woefully underinclusive in its reach. Aside from the many other ways in which the vice of greed may be exercised legally in our society, as was shown above, there are a number of circumstances where persons appear free to trade on material nonpublic information without violating insider trading laws (e.g., where the material nonpublic information is acquired by eavesdropping or dumb luck, where the tipper does not benefit but the tippee does, where the misappropriator announces an intent to trade to the source, or where the insider or misappropriator abstains from buying or selling based on material nonpublic information).

C. Sociopsychological Explanation: Theory of Cognitive Dissonance

If current social attitudes about nonpromissory insider trading and its criminalization cannot be justified on grounds of immorality or moralism, then it still remains for them to be explained, perhaps as the result of some sociopsychological phenomenon. Kahan and Posner offer an account of how a harmless form of insider trading might come to be criminalized and later perceived as morally wrong.[244]

According to Kahan and Posner, insider trading, like sodomy and abortion, are "examples of behavior that are at different times and places considered morally culpable or not."[245] Kahan and Posner offer a hypothetical sequence of events that might explain how such changes in attitudes may come about. Imagine a society in which the general public considers insider trading harmless. Then imagine that insider trading is identified in that society with some unfortunate event like a stock market crash: "No one knows whether the insider trading caused the crash, but some entrepreneur—maybe a government official—seizes the moment, blames the stock market crash on the insider traders, and starts prosecuting insider traders by exploiting some vague law."[246] Whether or not everyone buys into this rhetoric at first, some, "maybe those who never engaged in insider trading because they never had the chance," might pile on.[247] If a critical mass jumps on this bandwagon, a

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[243] JOHN STUART MILL, ON LIBERTY 22 (2d ed. 1859).

[244] Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365 (1999).

[245] *Id.* at 376.

[246] *Id.* at 377.

[247] *Id.*

new equilibrium is established in which those who might profitably trade on insider information refuse to do so (even if they see nothing wrong with it), both to remain law abiding and to avoid the reputational damage that comes with criminal liability.[248] The result is that eventually "only bad types" (those who don't care about being law abiding or about their reputation) engage in insider trading.[249] This empirical fact then further reinforces the behavior: people will refrain from insider trading for the additional reason that they do not want to be mistaken for a bad type. Ultimately, to avoid cognitive dissonance (i.e., engaging in action inconsistent with ones beliefs), those who originally believed there was nothing wrong with insider trading will actually revise their beliefs about the morality of insider trading to cohere with the reputational and criminal consequences they impose on others for such behavior.[250] They "convince themselves, through a psychological process that is not well understood, that not only do bad people engage in insider trading but that insider trading is morally wrong."[251] This account offered by Kahan and Posner is particularly helpful in that it offers a clear sociopsychological explanation of the paradoxical attitudes that empirical studies have shown are in fact held by the public with respect to insider trading. Studies have shown the average citizen has strong intuitions that insider trading is wrong, but is unable to explain why.[252]

D. Envy and Insider Trading

Even if the theory of cognitive dissonance offers the best explanation of how nonpromissory insider trading came to be criminalized and then regarded as immoral in our society, an important element seems to be missing from the narrative. Recall that social attitudes regarding insider trading in the Kahan and Posner hypothetical did not begin to change until enough people jumped on the prosecutor's bandwagon to reach a tipping point. Given that the hypothetical presumes a starting point at which insider trading is generally regarded as harmless, it seems more must be said about the motivations of the prosecutor and those who initially side with him. Kahan and Posner suggest that many will be motivated by the desire to "reveal, by contrast, the purity of their own behavior."[253] In other words, the prosecutor offers them an opportunity to signal to others that they are free of all responsibility for the social problem and at the same time gain a reputational advantage by helping to "out" those who were responsible. The

[248] *Id.*
[249] *Id.*
[250] *See id.* at 378.
[251] *Id.* at 378.
[252] *See, e.g.*, Green & Kugler, *supra* note 5, at 484 ("Although our subjects seemed to have strong intuitions that insider trading is wrong, they were unable to isolate the victim in one case from the victim in another. In an interesting turn, we think this result suggests that professionals and the lay public are united in their confusion over the rationale for prohibiting insider trading.").
[253] Kahan & Posner, *supra* note 244, at 377.

motivation to find scapegoats in the wake of a painful event like a market crash or economic downturn can of course be powerful, but for our purposes, we still need an explanation of why nonpromissory insider traders would make for promising targets. Contempt for the greed displayed by some insider traders discussed above offers one possible motivation (though, again, it is not a justification). Another possible motivation may be envy.

Rawls defines envy as "the propensity to view with hostility the greater good of others even though their being more fortunate than we are does not detract from our advantages."[254] Rawls goes on, we "envy persons whose situation is superior to ours . . . [when] we are willing to deprive them of their greater benefits even if it is necessary to give up something ourselves."[255]

The vast sums that can be (and are) gained with little risk by insider traders cannot be ignored as a possible source of public envy, particularly in dire economic times. The average citizen is often struck by the immense compensation that Wall Street executives receive. But the reaction is typically more like the reaction to a professional athlete's salary: we wonder how anyone could be worth that much, but we may not be envious because we know that we could never do what those people can do, or we would never want a job like that. The insider trader, however, is different. The average citizen could do what the insider trader does. It does not take any special skill. This is where the envy comes in—envy at the good fortune of these traders who receive "an easy buck."[256]

Envy must be distinguished from resentment. According to Rawls, "[R]esentment is a moral feeling. If we resent our having less than others, it must be because we think that their being better off is the result of unjust institutions, or wrongful conduct on their part."[257] Envy, by contrast, cannot be justified by appeal to moral principle. To explain envy, "[i]t is sufficient to say that the better situation of others catches our attention. We are downcast by their good fortune and no longer value as highly what we have; and this sense of hurt and loss arouses our rancor and hostility."[258]

If the arguments offered above are to be credited, the criminalization of nonpromissory insider trading cannot be explained as an expression of public resentment unless such resentment is misplaced or deluded. Nonpromissory insider trading violates no other-regarding principles of justice or morality. Thus, if contempt for the profits of insider traders has offered some motivation for society's attitudes concerning nonpromissory trading and its criminalization, it is envy, pure and simple.

This conclusion causes concern for two reasons. First, envy is generally regarded as one of the worst vices. This is because the perverse goal of envy is the

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[254] RAWLS, *supra* note 189, at 532.

[255] *Id.*

[256] For an excellent treatment of the vice of envy in this context, see Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005).

[257] RAWLS, *supra* note 189, at 533.

[258] *Id.*

destruction of what is good solely to see another deprived of it.[259] In fact, Aristotle describes envy as a perfect or "unconditional" vice because it cannot admit of moderation. According to Aristotle, envy's name alone (like "murder") implies badness.[260] Kant describes envy as the vice of "hatred for human beings."[261] Thus, to the extent envy explains our harsh punishment of nonpromissory insider traders, it would be an expression of our own vice, not the traders'. Second, the prevalence of such envy itself risks economic and political instability. As Rawls explains, not only are the envious prepared to do things that make both themselves and the objects of their envy worse off, "if only the discrepancy between them is sufficiently reduced,"[262] but when the objects of envy realize they have been targeted, "they may become jealous of their better circumstances and anxious to take precautions against the hostile acts to which [others'] envy makes [them] prone."[263] For example, the objects of envy may, at some cost to themselves, take measures to further diminish the position of those who are envious, or at least prevent them from gaining further power. Such action only compounds the animosity between the envied and the envious, and the result is increased social instability and diminished positions for all. Thus, envy is not just harmful to the envious person's character; it is collectively destructive. Indeed, it has been argued that some of the worst social horrors in the modern world (racism, anti-Semitism, and terrorism) have been planted with the seed of envy.[264]

VI. CONCLUSION

It is time to reconsider our insider trading enforcement regime. While promissory insider trading and misappropriation trading are indeed impermissible from the utilitarian and deontological moral perspectives, corresponding utilitarian and retributivist theories of punishment may not support the severity of the penalties currently imposed. But of more concern, this Article demonstrates that nonpromissory insider trading does not cause identifiable economic harm and turns out to be permissible under both utilitarian and deontological moral theories. Consequently, the current criminalization and punishment of such trading cannot be justified in terms of economic efficiency or the principal moral theories informing Western liberal jurisprudence. Having reached this conclusion, alternative justifications or explanations for the criminalization of nonpromissory insider trading were explored. If the criminalization of nonpromissory insider trading is motivated by society's contempt for the character flaw of greed, then such criminalization is overbroad, impermissibly moralistic, and violates Mill's

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[259] Schroeder, *supra* note 256, at 2031.

[260] ARISTOTLE, *supra* note 237, at 45.

[261] KANT, *supra* note 198, at 206; *see also* Schroeder, *supra* note 256, at 2027. Schroeder argues that envy is "second only to pride in its potentially corruptive effect on the soul. As etymology reveals, envy—*invidia*—is the most invidious sin." *Id.*

[262] RAWLS, *supra* note 189, at 532.

[263] *Id.*

[264] *See* Schroeder, *supra* note 256, at 2031.

liberal harm principle. But worse, if such criminalization is motivated by envy, we may not only be doing a grave moral wrong to these traders by imposing harsh criminal penalties for morally innocent conduct; we may also be contributing to social instability and giving expression to the worst in ourselves.