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The Final Step to Insider Trading Reform: Answering the "It's Just Not Right!" Objection

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THE FINAL STEP TO INSIDER TRADING REFORM: ANSWERING THE "IT'S JUST NOT RIGHT!" OBJECTION

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INTRODUCTION

One of the most often quoted passages in Henry Manne's seminal book, *Insider Trading and the Stock Market*, occurs where Manne lumps together arguments against insider trading that turn on considerations of ethics or fairness as "it's just not right" propositions.[1] In a footnote, Manne explains that this expression originated with an anonymous lady law student, who, during a classroom discussion of the subject, stamped her foot and angrily declared, "I don't care; it's just not right."[2]

For Manne, if repetition of such moral exhortations "were a form of scientific proof, undoubtedly the case against insider trading would long ago have been proved."[3] Such cynicism concerning ethical justification in the law can be traced back to the early legal realists,[4] but it has been particularly pronounced among members of the modern law and economics movement, of which Manne was, of course, a founder. The criticism seems to be that, by comparison to economic analysis, ethical justification is insufficiently "rigorous" or "scientific" to determine clear and effective legal principles.

Indeed, Manne (like many other leaders of the law and economics school) was of the opinion that most, if not all, first-order ethical propositions ultimately rest on economic justifications—that what is *right* can usually be cashed out in terms of what is *efficient*. I think this view is mistaken. But more important for the topic at hand, I think this view is counter-

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1 HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 15 (1966).

2 *Id.* at 15, n. 42.

3 *Id.* at 15.

4 *See, e.g.*, Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARVARD L. REV. 457, 464 (1897) ("I often doubt whether it would not be a gain if every word of moral significance could be banished from the law altogether.").

productive to those of us who share the opinion that the current insider trading enforcement regime is in desperate need of liberalization and reform.

The problem is that, despite the fact that the economic analysis of Manne, Jonathan Macey,[5] Dennis Carlton & Daniel Fischel,[6] Todd Henderson,[7] and others have been successful in showing that the current insider trading enforcement regime is highly inefficient, most academics, politicians, regulators, and journalists continue to justify it in ethical terms.[8] With the principals to the debate speaking at cross-purposes, the result is a standoff that favors the status quo and precludes reform. This reality has led most commentators, even those of an economic bent, to reach the conclusion that the current insider trading enforcement regime "is doubtless here to stay."[9] This is a serious problem because, in addition to being inefficient, the current insider trading enforcement regime is unjust, incoherent, and irrational.

This Article proceeds as follows: Section I sets the table by dismissing the notion that economic analysis of law should enjoy some privileged status (as more precise, rigorous, or scientific) over ethical analysis of law. Rather, it is suggested that economic and ethical reasons are best understood as different tools suited for different roles in legal reform. It is then argued that, given the current climate, ethical reasoning is the best tool for overcoming the remaining obstacles to insider trading reform in the United States. Section II begins the ethical analysis by arguing that even if it were admitted that insider trading harms society and is morally wrong, the current enforcement regime would still be unjust, incoherent, irrational, and in desperate need of reform. Section III proposes the legalization of issuer-licensed insider trading as one effective means of reforming the current regime but anticipates the "it's just not right" objection. Section IV confronts the "it's just not right" objection on its own ethical terms and demonstrates that, while it is true that some forms of insider trading are not morally permissible on either consequentialist or deontological grounds, issuer-

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5 *See generally*, Jonathan R. Macey, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY (1991).

6 *See generally*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN L. REV. 857 (1983).

7 *See generally*, M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 505 (2011).

8 *See, e.g.*, Peter J. Henning, *What's So Bad About Insider Trading Law*, 70 BUS. LAW. 751, 775 (2015) ("There are questions about whether [the current insider trading enforcement regime] is the best . . . from an economic viewpoint to encourage efficient trading, but that is likely not the only goal in prohibiting trading that carries a stigma of unfairness and cheating.").

9 STEPHEN BAINBRIDGE, INSIDER TRADING: LAW AND POLICY 207 (2014). Even Manne himself hinted at some resignation in this regard. In email correspondence, he expressed frustration that "Judge Posner recently said that he didn't see that there was any basis for arguing about [insider trading] since people just don't like it!"). Email from Henry Manne to John P. Anderson (Sept. 6, 2012, 20:48 UTC) (on file with author).

licensed insider trading *is* morally permissible. Nevertheless, some object to insider trading, not on consequentialist or deontological moral grounds, but because it reflects the vice of greed. Section V closes by addressing this ethical concern. It is argued that criminalizing issuer-licensed insider trading is not only a poor means of combating the character flaw of greed, but that criminalization on such grounds would be moralistic (like laws against sodomy or same-sex marriage) and would therefore conflict with our society's increasingly shared repugnance toward such laws. Finally, if our criminalization of issuer-licensed insider trading cannot be justified on moral or ethical grounds, it must be explained. Some have suggested that society's envy of those who earn "easy money" offers the explanation. However, envy is perhaps the worst of all vices, and the Article closes by cautioning against its seduction.

I. ETHICS AND ECONOMICS: CHOOSING THE RIGHT TOOL FOR THE JOB

Richard Posner echoes the view of many proponents of the law and economics movement when he writes that the "compartmentalization of knowledge—so conspicuous a feature of the modern world—may have condemned [ethical theory] to irrelevance at the level of practice."[10] For Posner, the legal problems facing rich liberal countries in the twenty-first century

> present difficult analytical and empirical issues that can no more be understood, let alone resolved, by the intuitions and analytic procedures of persons schooled only in the humanities than problems of high-energy physics or brain surgery can be understood and resolved by the study of the *Tractatus Logico-Philosophicus*.[11]

Posner is fond of dismissing ethics as a mode of legal justification by claiming that such appeals may "persuade, but not with rational argu-

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[10] RICHARD POSNER, OVERCOMING THE LAW 446 (1995).

[11] *Id.* at 456. Published in 1921, Ludwig Wittgenstein's *Tractatus* is regarded as one of the most esoteric yet important works of twentieth century philosophy. The book aims to define the limits of science and metaphysics. It was extremely influential among logical positivists and early philosophers of language. In his later work, Wittgenstein distanced himself from the "dogmatism" of the *Tractatus*. The later Wittgenstein eschewed the *Tractatus's* attempt at logical precision in favor of a pragmatism that regards philosophy as nothing more (or less) than a therapeutic tool that is most useful in "language games" that are divided against themselves, with participants working at cross purposes. In such cases, philosophy's task is to expose the problem and thereby help to "shew the fly the way out of the fly bottle." LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS § 309 (G.E.M. Anscombe, trans., 3rd ed. 1967). With this in mind, I suggest that though Wittgenstein would agree with Posner's conclusion that his *Tractatus* is of little use in the language games played by surgeons and physicists as such, he would also be sympathetic to the thesis of this Article, which is that there are some dysfunctional language games, of which our current insider trading enforcement regime is one, within which the tools of ethical philosophy can be of great practical import by perhaps showing the fly out of the bottle!

ments."[12] For Posner, "[a]t its best, moral philosophy, like literature, enriches; it neither proves nor edifies."[13] Good economic analysis of the law, by contrast, is purported to offer firm, rational grounds for its conclusions that are objectively verifiable. It is argued that economic analysis "epitomizes the operation in law of the ethic of scientific inquiry, pragmatically understood," and is therefore far better suited than ethical reasoning to the challenges of the age.[14] In sum, economic analysis, which is science, should be privileged over ethical analysis, which reduces to nothing more than "epistemically feeble"[15] exhortation, when analyzing and justifying the law. But even Posner must admit that things are not that simple.

First, without the aid of ethical justification, micro-economics can never hope to bridge the "is/ought gap"—it can never hope to transform its descriptions of market behavior to prescriptions for reform.[16] As Posner himself explains, "nothing in economics prescribes an individual's goals. But whatever his...goals," rational choice theory provides a tool for charting the most efficient path to achieving them.[17] The first inquiry, then, is always what are your goals? Or, as a legal community, what are *our* goals? In most cases, this question can only be answered by an appeal to our ethical values, our conceptions of what is good and what is right. When there is dispute over these goals, only ethical reasons can resolve them. In this sense, ethical reasoning is logically prior to economic reasoning as tool for social reform. In sum, ethics must be relied upon to set our ends, and economics are at most instrumental to achieving them.

But I think Posner's real frustration with ethical justification in the law is that, however that justification is articulated, it offers no rational or objective grounds. While it may persuade, it does so with grunts and cheers, not "rational argument." It is the same frustration Manne expresses over his student's foot-stomping. For Posner, moral claims once espoused by Enlightenment proponents like Locke, Rousseau and Jefferson as universal

12 RICHARD POSNER, THE PROBLEMATICS OF MORAL AND LEGAL THEORY, at ix (1999).

13 *Id.* at 32.

14 POSNER, *supra* note 10, at 15.

15 POSNER, *supra* note 12, at 12.

16 The is/ought gap refers to the fallacy of trying to derive a normative conclusion (an "ought") from purely descriptive ("is") premises. The philosopher David Hume is credited as the first to give expression to this problem (sometimes referred to as "Hume's Guillotine" or the "naturalistic fallacy"):

> In every system of morality which I have hitherto met with, I have always remarked that the author proceeds for some time in the ordinary way of reasoning, and establishes the being of a god, or makes observations concerning human affairs; when of a sudden I am surprised to find that instead of the usual copulations of propositions *is* and *is not*, I meet with no proposition that is not connected with an *ought* or an *ought not*. This change is imperceptible, but is, however, of the last consequence. For as the ought or ought not expresses some new relation or affirmation, it is necessary that it should be observed and explained; and at the same time that a reason should be given for what seems altogether inconceivable, how this new relation can be a deduction from others which are entirely different from it.

DAVID HUME, MORAL AND POLITICAL PHILOSOPHY 43 (Henry D. Aiken, ed., 1948).

17 POSNER, *supra* note 10, at 16.

and rationally demonstrable are today "better understood as just the fancy dress of workaday social norms that vary from society to society."[18] But this leads to my second point. Even assuming *arguendo* that Posner is correct to claim that ethical propositions are not objective, the contingent and provincial nature of an ethical claim does nothing to diminish its rational force within the culture or practice that avows it. In other words, moral relativism need not be vicious or pernicious. For example, the fact that individual autonomy is not valued as highly in some Asian cultures does not undermine its crucial importance within our own constitutional culture. Moreover, once definitions are fixed and inferential relations are set, ethical analysis can be every bit as precise, rigorous, and testable as can microeconomic analysis. Of course the devil is often in fixing those definitions and relations to our audience's satisfaction, but those devils are just as pesky when setting up microeconomic models. I am reminded of George E. P. Box's statement that is so often repeated by economists, "all models are wrong, but some are useful."[19]

None of the above is intended to turn the table on Posner and make the claim that economic analysis must always take a back seat to ethics in justifying existing law or proposing a legal reform. Quite often, indeed most of the time, the "end" set by ethics is not in dispute but rather, only the most appropriate means to that end. When this is true, economic analysis will rightly dominate the debate over needed reform. But insider trading regulation in the United States offers one of those relatively rare situations where, thanks to the excellent work of Manne and others, the economic stakes of enforcement are now fairly well-defined, but few seem able to agree on its *ends*. There seems to be broad consensus that liberalizing the current regime would improve efficiency. Resistance to such liberalization, however, comes almost exclusively from those who are concerned that any such liberalization would render markets unjust or unfair and would only spread the current epidemic of greed on Wall Street.

If your only tool is a hammer, every problem looks like a nail. The frustration and resignation of many advocates for insider trading reform stems from the fact that they persist in making strong economic arguments to address a problem the public no longer frames in economic terms. They speak at cross-purposes with their adversaries, and the resulting standoff favors the status quo. Economics is simply the wrong tool for the job that remains. The last step to insider trading reform consists of winning the hearts and minds of those who resist it. This demands advocacy that draws upon ethical theory and the paradigms of justice, fairness, and the good which are latent within our public political culture. In what follows, I sketch out how some of these arguments might look.

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18 POSNER, *supra* note 12, at 6.

19 GEORGE E.P. BOX & NORMAN R. DRAPER, EMPIRICAL MODEL-BUILDING AND RESPONSE SURFACES 424 (1987).

II. CURRENT ENFORCEMENT REGIME IS UNJUST AND IRRATIONAL–REFORM IS NEEDED

I have argued elsewhere that the current insider trading enforcement regime in the United States is unjust, incoherent, and irrational.[20] Under the current regime, draconian penalties[21] are imposed for a crime which has never been defined by statute or rule.[22] The principal statutory authority for insider trading liability is Section 10(b) of the Securities Exchange Act of 1934, which prohibits the employment of "any manipulative or deceptive device or contrivance [in] connection with the purchase or sale, of any security."[23] Though Section 10(b) functions as a "catch-all" provision, the Supreme Court has made it clear that "what it catches must be fraud."[24] But insiders typically gain their advantage by withholding their material nonpublic information while trading over anonymous exchanges. The common law only regards such silence as fraudulent when there is some duty to disclose. The Supreme Court recognizes such a duty under two theories, the "classical theory" and the "misappropriation theory."[25]

Insider trading liability arises under the classical theory when the issuer, its employee, or someone otherwise affiliated with the issuer seeks to benefit from trading (or tipping others who trade) that firm's shares based on material nonpublic information. In such cases, the insider (or construc-

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20 *See generally*, John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014, UTAH L. REV. 1 (2014) [hereinafter *Greed & Envy*]; John P. Anderson, *Anticipating a Sea Change for Insider Trading Enforcement Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV . 339 (2015) [hereinafter *Anticipating a Sea Change*]; John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795 (2015); John P. Anderson, *Solving the Paradox of Insider Trading Compliance*, 88 TEMPLE L. REV. 273 (2016) [hereinafter *Paradox of IT Compliance*]; John P. Anderson, *When Does Corporate Criminal Liability for Insider Trading Make Sense?*, STETSON L. REV.. (forthcoming).

21 *See, e.g.*, Stephen Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995) ("insider trading . . . carries penalties that can only be described as draconian) [hereinafter, *State Law Fiduciary Duties*]. With the passage of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), the civil penalty of treble damages now applies to firms as well as individuals. Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. § 78 (2012)). With the passage of the Sarbanes-Oxley Act of 2002, the individual criminal penalty was raised to a fine of up to $5 million and imprisonment up to 20 years per violation. Non-natural persons (i.e. firms) are subject to fines of up to $25 million. 15 U.S.C. § 78ff(a). As one author points out, under "the federal guidelines, the maximum sentence for insider trading is nineteen to twenty-four years, while a rapist could get fifteen years to life in prison." CHARLES GASPARINO, CIRCLE OF FRIENDS 155 (2013).

22 As Stephen Bainbridge puts it, "the modern prohibition [of insider trading] is a creature of SEC administrative actions and judicial opinions, only loosely tied to the statutory language and its legislative history." SECURITIES LAW: INSIDER TRADING (2d ed. 2007).

23 15 U.S.C. § 78j(b) (2012).

24 Chiarella v. United States, 445 U.S. 222, 234-35 (1980).

25 *See* United States v. O'Hagan, 521 U.S. 642, 651-53 (1997).

tive insider) violates a "fiduciary or other similar relation of trust and confidence" to her counterparty, the shareholder (or prospective shareholder) on the other side of the trade.[26] Insider trading liability arises under the misappropriation theory when one misappropriates material nonpublic information and then trades on it without prior notice to the source. The "misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to the confidential information" by cheating them out of "the exclusive use of that information."[27]

A. *Insufficient Notice of Crime*

The fact that it has never been defined by statute leaves us with the "jurisprudential scandal that insider trading is largely a federal common law offense."[28] The Western liberal jurisprudential tradition is suspicious of common law crimes like insider trading because they often violate the principle of legality, which is sometimes expressed in the Latin phrase, ***nullum** crimen sine lege*.[29] The principle of legality holds that "there must be no crime or punishment except in accordance with fixed, reasonably specific, and fairly ascertainable preestablished law."[30] This principle gives expression to our shared intuition that justice requires that persons be given reasonable notice of when criminal sanctions will be imposed. Otherwise persons would be left helpless to plan their lives to avoid such sanctions. The same moral intuition informs our repugnance towards *ex post facto laws*.[31]

The history of U.S. insider trading enforcement offers a sad illustration of the perniciousness of common law crimes. For example, federal regulators imposed sanctions on individuals pursuant to the "equal access" or "parity-of-information" model of insider trading liability for over two decades before this model was ultimately rejected by the Supreme Court as inconsistent with its statutory authority in Section 10(b).[32] Moreover, de-

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26 *Chiarella*, 445 U.S. at 228.

27 *O'Hagan*, 521 U.S. at 652.

28 Jeanne Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159, 163 (2014).

29 *See e.g.*, DAVID A. J. RICHARDS, THE MORAL CRITICISM OF LAW 195 (1977).

30 *Id.*

31 Such laws are, of course, unconstitutional pursuant to U.S. Const. art. I §§ 9-10.

32 In 1968, the Second Circuit adopted the SEC's preferred equal access model for insider trading liability. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (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"). It took twenty-two years for this interpretation to reach the Supreme Court, when it was expressly rejected in favor of the fiduciary model now in place. The Court explained that 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 to parties . . . should not be undertaken absent some explicit evidence of congressional intent." *Chiarella*, 445 U.S. at 233.

spite the fact that the Supreme Court's decision in *Chiarella v. United States* left the legal status of the misappropriation theory of insider trading liability uncertain, regulators continued to enforce it for the next seventeen years before it finally received the Court's imprimatur in *United States v. O'Hagan*.[33] The SEC and prosecutors continue to press for broader insider trading enforcement authority, and they would rather ask forgiveness than permission from the courts. Without a statutory definition, market participants are just left guessing as to whether that expanded authority will be recognized by some judge. Most would rather settle than take the risk, which is precisely the injustice the principle of legality looks to avoid.

It is worth noting that simply codifying the current working definition of insider trading would not solve the problem. Injustice due to inadequate notice would persist because the current definition's terms are hopelessly vague. Both the classical and misappropriation theories impose liability on those who seek to "benefit from trading . . . on the basis of material non-public information" in violation of a "fiduciary or other similar relation of trust and confidence," but few agree on the definition of any one of these terms.[34] In *Connally v. General Construction Company*, the Supreme Court held that a law violates due process when a person of "common intelligence must necessarily guess at its meaning."[35] Some scholars have suggested that the law against insider trading is unconstitutionally vague.[36] Indeed it is hard to disagree with Steven Cohen, founder of SAC Capital Advisors, LP, and the target of multiple insider trading investigations, when he says "[i]t's my belief that the rule [against insider trading] is vague, and therefore . . . as a lawyer, you can interpret it in lots of different ways."[37] As Professor Homer Kripke put it more generally, "fraud" in Rule 10b-5 has "come to mean anything that the SEC dislikes because by picking cases in which it can dramatically describe the facts, the SEC hopes that the facts will carry the law."[38] The latter concern, that regulators may exploit vagueness in the law to pursue their own institutional or even personal agendas, is shared by Justice O'Connor in *Kolender v. Lawson*:[39]

> [T]he more important aspect of vagueness doctrine "is not actual notice, but . . . the requirement that a legislature establish minimal guidelines to govern law enforcement." (citation omitted). Where the legislature fails to provide such minimal guidelines, a criminal statute

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33 United States v. O'Hagan, 521 U.S. 642, 652-53 (1997).

34 *See, e.g.*, Anderson, *Paradox of IT Compliance*, *supra* note 20, at 278-87 (quoting *Chiarella*, 445 U.S. at 228).

35 269 U.S. 385, 391 (1926).

36 *See, e.g.*, Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 949 (1985).

37 Greg Ferrell, *SAC's Cohen May Face SEC Suit as Deposition Hurts Case*, BLOOMBERG (Feb. 19, 2013, 5:00 PM), http://perma.cc/CY9K-KLNW.

38 Kripke, *supra* note 36, at 949.

39 Kolender v. Lawson, 461 U.S. 352 (1983)

> may permit "a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections.[40]

U.S. Circuit Court Judge Barrington Parker expressed this concern during oral argument in *United States v. Newman*[41] when he challenged the government's "amorphous theory" of insider trading liability as leaving "all these institutions at the mercy of the government."[42] And there is evidence to suggest that abuse has occurred in the context of insider trading enforcement.

B. *Abuse of Discretion*

For instance, some have noted that enforcement officials and prosecutors are wont to "exploit the hostile reaction [insider trading] provokes among the general public" to "generate positive publicity" for themselves (or to deflect criticism) in the wake of market downturns.[43] For example, in the wake of the sub-prime mortgage meltdown of 2008, the government needed "a white collar scandal that it could tout as having successfully prosecuted to satisfy the public's demand for Wall Street scalps."[44] Insider trading prosecutions offered the anodyne for wounded political reputations: "[I]nsider trading was viewed as the easiest way to restore the [SEC's] reputation following the Madoff catastrophe and the image hit taken in the aftermath of the financial crisis."[45] The government's "amorphous theories" of insider trading liability permitted it to rack up scores of white collar scalps at a near perfect conviction rate. These efforts put United States Attorney for the Southern District of New York, Preet Bharara, on the cover of *Time Magazine* with the headline, "This Man Is Busting Wall St."[46] The fact that insider trading had nothing to do with the financial collapse was not important. Decades before, similar concerns were raised that then-United States Attorney Rudolph Giuliani sensationalized his insider trading cases in the 1980s for political purposes, and to support his immanent "bid for public office."[47]

It has also been suggested that insider trading enforcement has been exploited by the SEC in its turf wars with other agencies over money, juris-

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40 *Id.* at 358 (quoting Smith v. Goguen, 415 U.S. 566, 574-75 (1974)).

41 United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014).

42 *See* Nate Raymond, *U.S. Prosecutor Grilled over Insider Trading Definition in Key Appeal*, REUTERS (Apr. 22, 2014, 3:31 PM), http://www.reuters.com/article/insidertrading-appeal-idUSL2N0NE0OR20140422 (quoting U.S. Circuit Judge Barrington Parker).

43 Henning, *supra* note 8, at 762.

44 GASPARINO, *supra* note 21, at 17.

45 *Id.* at 201.

46 Massimo Calabresi & Bill Saporito, *The Street Fighter*, TIME, Feb. 13, 2012, at 22.

47 JAMES B. STEWARD, DEN OF THIEVES 383 (1992).

diction, and prestige. Professor Stephen Bainbridge explains that, according "to one widely accepted theory of bureaucratic behavior, administrators can maximize their salaries, power, and reputation by maximizing the size of their agency's budget."[48] And Professor Macey claims that the SEC's "politicization of the insider trading issue" enabled it to "double its budget by arguing that more resources were necessary to combat [what it had convinced the public was a] dire national emergency."[49]

It is clear that money matters to prosecutors and the SEC every bit as much as it does to the insider traders they prosecute. For instance, in the 1980s, the SEC reached a $100 million settlement with Ivan Boesky, but they needed him to sell his portfolio to get it. The SEC knew that news of Boesky's arrest would send the market into a tailspin, so it "directed Boesky to begin liquidating some of his holdings during the two weeks preceding the announcement."[50] In other words, the SEC directed Boesky to trade on the material nonpublic information of his own charges and settlement to protect their $100 million fine. The other arbitrageurs (and regular traders) betting alongside Boesky were livid when news of the SEC's complicity hit. The irony was not lost on the press either. The *Washington Post* ran a front-page story titled, "Wall Street Lambastes SEC Action: Agency Reportedly Let Beosky Sell Off Stocks in Advance."[51] One trader, David Nolan, noted that "[t]he SEC has unwittingly aided one of the largest insider trading scams in history."[52] Not long after providing this quote to the *Post*, Mr. Nolan himself was investigated for insider trading, which raises another concern.[53]

As one commentator explains, the "government, being the government, can always find something to charge you with, and they will do so if you rub their noses in it."[54] Vague and amorphous prohibitions like insider trading are ready weapons for government agencies to retaliate against political enemies or to bully those who refuse to do their bidding. In 2014, Nelson Obus, whose hedge fund was the target of an insider trading enforcement action, authored a *Wall Street Journal* commentary entitled, "Refusing to Buckle to SEC Intimidation."[55] In it, Obus paints the picture of a

48 Bainbridge, *State Law Fiduciary Duties*, *supra* note 21, at 1246.

49 MACEY, *supra* note 5, at 4.

50 STEWARD, *supra* note 47, at 337.

51 David A. Vise & Michael Schrage, *Wall Street Lambastes SEC Action: Agency Reportedly Let Boesky Sell Off Stocks in Advance*, THE WASHINGTON POST, Nov. 21, 1986, at A1.

52 *Id.*

53 STEWARD, *supra* note 47, at 345.

54 GASPARINO, *supra* note 21, at 230. The reference here is to John Kinnucan, an independent research analyst who refused to wear a wire for the government and was eventually convicted of securities fraud. Kinnucan is best known for his colorful (and often racist) email rants criticizing the government. Gasparino's book offers a detailed account of these events.

55 Nelson Obus, *Refusing to Buckle to SEC Intimidation*, WALL ST. J. (June 24, 2014, 7:37 p.m.) http://www.wsj.com/articles/nelson-obus-refusing-to-buckle-to-sec-intimidation-1403651178.

twelve-year SEC enforcement process that was short on substance and long on political motives. Vagueness in the law and virtually unlimited resources permitted the SEC to press even a weak case for over a decade at a cost of $12 million in legal fees.[56] According to Obus, the SEC attempted to "bully" him into a settlement, but he refused to admit guilt since he had done nothing wrong.[57] Obus expresses concern that "not many small firms could be expected to weather such a storm from a system that provides regulators with every incentive to overreach without repercussions" and he worries that most will be forced to "settle or falsely admit wrongdoing."[58]

C. *Current Regime Is Incoherent*

In addition to being unjust for the reasons already stated, the current U.S. insider trading enforcement regime is incoherent. This incoherence is due to the fact that it is driven by two competing and irreconcilable rationales. The SEC and federal prosecutors continue to press for a parity of information (or at least equal access) regime through their rulemaking authority and prosecutorial discretion. The judiciary, on the other hand, remains committed to the fraud-based model reflected in the language of Section 10(b). The unsurprising result of this schizophrenia has been that in practice neither model is effectively implemented, and everyone is left guessing.

To begin, if the current regime is judged by the SEC's own stated goal of achieving a "level playing field" by guaranteeing that all market participants have equal access to information, then it is woefully under-inclusive in its reach.[59] There are a number of forms of willful securities trading based on material nonpublic information that are not proscribed under the current fiduciary-duty-based enforcement regime. For example, the current regime does not proscribe trading based on material nonpublic information acquired by eavesdropping or luck.[60] In *Dirks v. SEC*, the Supreme Court held that no Section 10(b) insider trading liability is incurred where a tippee trades on material nonpublic information that is provided by an insider who seeks no personal gain.[61] Additionally, in *United States v. O'Hagan*, the

56 *Id.*

57 *Id.*

58 *Id.*

59 *See, e.g.*, Marc I Steinberg, *Insider Trading Regulation—A Comparative Analysis*, 37 INT'L LAW 153, 158 (2003) ("The goal that ordinary investors play on a level playing field with market professionals, having equal access to material nonpublic information, no longer survives under Section 10(b) insider trading jurisprudence.").

60 *See, e.g.*, SEC v. Switzer, 590 F. Supp. 756, 765-66 (W.D. Okla. 1984) (relying on *Dirks v. SEC* to find that Switzer was not liable under Section 10(b) for trading on material nonpublic information he overheard at a track meet). *See also* Anderson, *Greed & Envy*, *supra* note 20, at 22-23.

61 Dirks v. SEC, 463 U.S. 646, 662 (holding that the test is whether the insider "personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach

Supreme Court explained that, since the "deception essential to the misappropriation theory involves feigning fidelity to the source of the information," there is no Section 10(b) liability for outsiders who brazenly announce to the source of the material nonpublic information that they intend to trade on it.[62] Finally, the law currently permits insiders to profit by abstaining from trading based on material nonpublic information. As Manne explains, insiders "can make abnormal profits in the stock market simply by knowing when *not* to buy and when *not* to sell,"[63] and the SEC only enhanced insiders' ability to profit from such strategic abstention by recognizing Rule 10b5-1 trading plans in 2000.[64] The selective termination of Rule 10b5-1 trading plans effectively grants insiders a cost-free option to buy or sell based on material nonpublic information.[65]

If, however, the current enforcement regime is instead judged by the fraud *cum* fiduciary standard articulated by the courts, it is over-inclusive in two important respects. First, common law fraud requires some knowing deception, or scienter.[66] The Supreme Court has consistently held that Section 10(b) liability requires "knowing or intentional misconduct."[67] However, in promulgating Rule 10b5-1(b) in 2000, the SEC seems to have effectively dropped the requirement of scienter for insider trading liability. The prelude to Rule 10b5-1 explains that the rule "defines when a purchase or sale constitutes trading 'on the basis of' material nonpublic information in insider trading cases brought" under Section 10(b) and SEC Rule 10b-5.[68] Rule 10b5-1(b) then goes on to define the mental-state requirement that trading be "on the basis of" material nonpublic information as demanding nothing more than "awareness" (or mere possession) of material nonpublic information while trading. The result is that an insider who sells shares for no other reason than to pay for her husband's emergency heart transplant is nevertheless liable for insider trading if she happened to be in possession of material nonpublic information at the time of the trade. As Professor Allan

of duty to stockholders [by the tipper]. And absent a breach by the insider, there is no derivative breach [by the tippee]"). *See also* SEC v. Maxwell, 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004) (no liability where insider tipped his barber because there was not benefit to the insider).

62 United States v. O'Hagan, 521 U.S. 642, 655 (1997). Indeed, Justice Thomas pointed out that under the current regime, "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." *Id.* at 689 (Thomas, J., concurring in the judgment in part and dissenting in part).

63 Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 938 (1985).

64 17 C.F.R. § 240.10b5-1 (2014).

65 *See,* Anderson, *Anticipating a Sea Change, supra* note 20, at 365.

66 *See* RESTATMENT (SECOND) OF TORTS § 525-6 (1977).

67 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). *See also* Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 155 (2003) (noting the Supreme Court "has repeatedly asserted that [Rule 10b-5] liability involves deceptive acts").

68 17 C.F.R. § 240.10b5-1 (2014).

Horwich puts it, "the SEC may have indulged in some linguistic legerdemain . . . arguably transforming a phrase that connotes a deliberate act . . . into something less."[69] Indeed, one commentator goes so far as to suggest that Rule 10b5-1 converts insider trading into a strict liability offense,[70] which is clearly inconsistent with the Supreme Court's announcement that though Section 10(b) was designed as a catch-all, "what it catches must be fraud."[71]

A second important way in which the current enforcement regime is over-inclusive under the fraud-based model is its proscription of issuer-licensed insider trading. I shall define what I mean by "issuer-licensed insider trading" in Section III below and explain why its proscription is inconsistent with a fraud-based theory of insider trading liability in Section IV below. For now I simply offer the promissory note that such trading is not deceptive and cannot therefore be coherently articulated as a form of Section 10(b) fraud.

D. *Current Regime Is Irrational*

The incoherence of the current regime combined with the vague and undefined elements of the offense leaves market participants guessing, and markets abhor uncertainty. The result is that the above-described dysfunction in the current regime often undermines many of the concrete market-related values the regulation of insider trading purports to promote. The current regime is therefore irrational.

The problem of insider trading compliance for issuers offers just one example. Faced with ambiguity in the law, issuers are unable to design effective compliance programs that identify and preempt only illicit trades. The only way for firms to protect against civil and criminal liability has been to adopt overbroad compliance programs. For example, issuers often impose overly restrictive pre-clearance standards for employee trading and excessively long blackout periods during which employees are precluded from trading altogether. However, I have argued elsewhere that these "play-it-safe" compliance policies come at a heavy price to firms in terms of corporate culture, cost of compensation, share liquidity, and cost of capital.[72]

First, ambiguity in the law forces compliance officers conducting pre-clearance interviews to view with skepticism employee claims that they are not trading the firm's shares based on material nonpublic information.

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69 Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW 913, 921 (2007).

70 *See* Swanson, *supra* note 67, at 151-52.

71 Chiarella v. United States, 445 U.S. 222, 234-35 (1980).

72 *See generally*, Anderson, *Paradox of IT Compliance*, *supra* note 20.

Such scrutiny of motives can lead to resentment on the part of employees. This resentment may in turn undermine the spirit of cooperation and mutual respect that is so important to a strong compliance culture, and to the firm's profitability.[73] Issuers could try to avoid this internal tension by turning the pre-clearance process over to outside counsel, but such outsourcing is expensive, and these costs are ultimately born by the shareholder.[74]

Second, it is common for corporate insiders to receive a large portion of their compensation in firm shares.[75] But the liquidity of these shares affects their value. Any restrictions the firm places on its employees' ability to monetize these shares will devalue them as compensation, forcing the company to issue more shares to employees to achieve the same remunerative effect.[76] This increased cost of compensation is, again, passed along to the firm's shareholders in lost share value.[77]

Third, employees often account for a large proportion of an issuer's outstanding shares.[78] So it stands to reason that significant restrictions on employee trading will decrease liquidity in the firm's shares. This decrease in liquidity will, in turn, increase the cost of capital to the firm.[79] Once more, these additional costs are ultimately born by shareholders in the form of lost share value.

I have referred to these problems together as composing the paradox of insider trading compliance for issuers.[80] Vagueness in the law of insider trading combined with the threat of harsh sanctions creates a perverse incentive to adopt inefficient compliance programs that can poison a corporate culture, decrease liquidity, increase cost of capital, and ultimately undermine shareholder value. The current regime is irrational to the extent that it undermines these important values which it purports to protect and promote.

All of this is to say that the current insider trading enforcement regime would be unjust, incoherent, irrational, and in desperate need of reform even if all the insider trading that is currently regulated were socially harmful and morally impermissible. In other words, even if the "it's just not

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73 *See id.* at 291.

74 *See, e.g.*, Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1180-82 (2003).

75 *See, e.g.*, Henderson, *supra* note 7, at 508 (Between 1999-2008, "the average public company executive earned more than half her total pay in the form of stock options or restricted stock.").

76 *Id.* at 509-10.

77 *See* Heminway, *supra* note 74, at 1174-77.

78 *See* Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. PA. L. REV. 801, 804 (2014) (citing a study suggesting that directors and officers own an average of twenty-four to thirty-two percent of a given firm's equity).

79 *See* Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223, 249 (1986) (noting that the greater a security's liquidity, the lower the expected return demanded by investors, which decreases the firm's cost of capital).

80 *See* Anderson, *Paradox of Compliance*, *supra* note 20, at 295.

right" objector to insider trading turned out to be correct, our shared commitment to justice, internal coherence, and rationality in the law would still suggest that the current insider trading enforcement regime be reformed. It turns out, however, that one of the forms of insider trading that is currently regulated, what I refer to as issuer-licensed insider trading, is harmless and morally permissible. In the next two sections I shall argue that liberalizing the current regime to legalize issuer-licensed insider trading would solve many of its current problems, but that accepting this reform will turn crucially on ethical justifications.

III. PROPOSED REFORM: EXPRESSLY AUTHORIZE ISSUER-LICENSED INSIDER TRADING

There is no single solution to the dysfunction that pervades the U.S. insider trading enforcement regime. I am, however, convinced that one reform would dramatically improve clarity, coherence, and rationality in the law, and it could be accomplished entirely through SEC rulemaking, without the need to amend Section 10(b). The proposed reform is the express authorization through SEC rulemaking of issuer-licensed insider trading. This modification to the current regime would permit issuers, at their discretion, to allow their employees to trade the firm's shares based on material nonpublic information so long as the following conditions are satisfied: [81]

(1) the insider submits a written plan to the firm that details the proposed trade(s);

(2) the firm authorizes that plan;

(3) the firm has previously disclosed to the investing public that it will permit its employees to trade on the firm's material nonpublic information through these plans when it is in the interest of the firm; and

(4) the firm discloses ex post all trading profits resulting from the execution of these plans.

It is important to note that this proposed reform would not affect the current regulation of issuer-proscribed insider trading (i.e., classical insider trading

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[81] I first proposed the following reform in *Anticipating a Sea Change*, *supra* note 20, at 380-81. *See also* Anderson, *Paradox of Compliance*, *supra* note 20, at 308.

where the insider trades based on material nonpublic information despite the fact that the issuer has prohibited such trading), nor would it affect the current regulation of trading under the misappropriation theory as defined above. As I explain below, both issuer-proscribed insider trading and misappropriation trading are economically harmful, morally wrong, and should continue to be proscribed.[82]

So how would authorizing issuer-licensed insider trading improve matters? The reform does not offer a statutory definition of insider trading, nor does it solve the problem of vagueness in insider trading's common-law elements. It does, however, bring relative certainty to a large, perhaps the largest, class of potential insider traders, namely issuers and the corporate insiders whom they employ. Issuers who are concerned about the risk of civil and criminal exposure for their trading and the trading of their employees could take refuge in the safe harbor offered by the reform. With the proper disclosures in place, they could be certain that any authorized trades in the firm's shares would not run afoul of the Section 10(b) insider trading regime. Corporate insiders themselves would enjoy the same certainty with any authorized trade, regardless of whether they possess material nonpublic information. In addition, this increased certainty for issuers and insiders would decrease the risk of abuse of regulatory and prosecutorial discretion.

This reform would also resolve the paradox of insider trading compliance for issuers.[83] By availing themselves of the safe harbor, firms would no longer feel compelled to preclude otherwise harmless trades for fear they might incur civil or criminal penalties. The firm's business judgment, not fear of regulatory scrutiny, would determine trading decisions and the liquidity of employee shares. If a firm rejects an insider's trading request and the employee trades anyway, then any regulatory action for insider trading would now be consistent with the firm's interests. In short, the proposed reform would virtually eliminate the heavy costs of insider trading compliance for issuers under the current regime, and it would bring the interests of issuers and regulators into complete alignment.

But there is a problem. The main objection to any reform package that includes an express safe harbor for issuer-licensed insider trading will be that such trading "is just not right!" Unless this challenge is confronted

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82 A strong argument can be made that, based on dicta from *Chiarella* and *O'Hagan*, issuer-licensed insider trading is already permitted under Section 10(b). *See* Anderson, *Anticipating a Sea Change*, *supra* note 20, at 385-86. *See also*, Henderson, *supra* note 7; Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM L. REV. 1491, 1515-20 (1999). Given, however, that the SEC would almost certainly challenge any such interpretation—and at least some lower courts would back them—no firm would (or should) take the risk of testing the theory absent clear guidance from the SEC.

83 This paragraph summarizes points made in Anderson, *Paradox of IT Compliance*, *supra* note 20, at 308-10.

directly, and in the ethical terms in which it is posed, the proposed reform cannot hope to succeed.

IV. WHY ISSUER-LICENSED INSIDER TRADING IS MORALLY PERMISSIBLE

For the reasons stated in Section II, the current insider trading regime would be unjust even if the conduct it sought to proscribe was itself morally impermissible. But, at least with respect to issuer-licensed insider trading, the proscribed conduct *is* morally permissible from the standpoint of the two principal moral theories informing Western liberal jurisprudence—consequentialism and deontology. It remains to sketch out some arguments to this conclusion, though there is no space here to develop them in detail.

To inquire into the moral permissibility of insider trading with any precision, it is first necessary to posit a legal regime that does not proscribe it. This allows us to separate our analysis of the morality of insider trading from the more general questions of when (if ever) it is morally permissible to violate the law, or when (if ever) it is permissible to violate the pre-arranged rules of a cooperative scheme.[84] The analysis below therefore assumes a regime that does not regulate any form of insider trading and then answers the question of whether, in such a regime, there would be ethical reasons for imposing such regulation.

Consequentialism identifies the rightness or wrongness of acts or rules with the goodness or badness of their consequences. There are two crucial elements to any consequentialist moral theory. First, the theory must define what is good. Defining the good provides the consequentialist with the criterion "for ranking overall states of affairs from best to worst from an impersonal standpoint."[85] Second, once the good is defined, consequentialism simply holds that the morally right action will be that which brings about the state of affairs that maximizes that good.[86]

Utilitarianism, which defines the good in terms of happiness or preference satisfaction, is by far the most prominent consequentialist theory. When utilitarianism is applied to the context of law, it tests the utility of legal *rules* and *principles* (rather than specific acts).[87] The principle of rule utilitarianism may be articulated as follows: "[T]he rightness or wrongness of an action is to be judged by the goodness and badness of the conse-

84 Professor Stuart Green, for example, has suggested that insider trading is morally wrong because it cheats the established market rules. STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE COLLAR CRIME 235-40 (2006). Such arguments are just not helpful when the question is whether there are moral reasons for regulating insider trading the first place.

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

86 *Id.*

87 J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANISM FOR & AGAINST 9 (2008).

quences of a rule that everyone should perform the action in like circumstances."[88]

Though there are certainly affinities between the economic analysis of law and rule utilitarianism (both are concerned with maximization strategies),[89] the former is not grounded in the latter, and the two approaches to law can sometimes conflict.[90] Nevertheless, economic analysis can be an effective tool for testing the social utility of certain conduct. And, indeed, it is fair to say that the economic analysis of insider trading offered by Manne and others takes us much of the way toward explaining when insider trading is and is not morally permissible on utilitarian grounds.

The economic consequences of insider trading have been hotly debated.[91] The most commonly cited economic benefits of insider trading include increased stock price accuracy,[92] real-time information to the markets[93] and to management,[94] its market-smoothing effect,[95] and its use as an

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88 *Id.*

89 Some see the link between utilitarianism and the economic analysis of law. *See, e.g.*, Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 150 (1993) (suggesting that utilitarianism is "the moral theory that underwrites the law and economics perspective").

90 *See, e.g.*, POSNER, *supra* note 10, at 403 ("the economic approach is neither deducible from nor completely consistent with [utilitarianism]"). Deviations will occur when rules promoting market efficiency fail to maximize overall social welfare—though rational choice theorists would argue this will rarely occur. For example, conflicts will arise where economic and moral conceptions of happiness differ (e.g., preference versus hedonistic, relative versus non-relative) and maximization differ (e.g., pareto efficiency versus the principle of utility). Moreover, recall that utilitarianism is just one form of consequentialism. If the good is defined as something other than happiness (think, e.g., perfectionist theories of the good), then it is easy to see how these approaches to law may come into conflict. *See, e.g.*, T. HURKA, PERFECTIONISM, 55-60 (1993).

91 For a more thorough summary of this debate, *see* Anderson, *Greed & Envy*, *supra* note 20, at 7-17.

92 *See, e.g.*, Carlton & Fischel, *supra* note 6, at 868 ("If insiders trade, the share price will move closer to what it would have been had the information been disclosed.").

93 Insider trading allows a company's insider's assessments of endogenous information to be reflected in its market price on a daily basis without the costs and delays associated with public filings and releases. *See id.* ("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.").

94 Real-time reflection of a company's information through its stock price can also inform upper management. For example, Manne pointed out that insiders often trade on nonpublic information concerning their company problems (fraud or other issues) that have not yet been brought to the attention of management. Any corresponding change in the stock price may raise a "red flag" to management and allow them to address the problem before it worsens. *See* Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 174-83 (2005).

95 As Professor Stephen Bainbridge explains, "[a]ccurate pricing benefits society by improving the economy's allocation of capital investment and by decreasing the volatility of security prices. This dampening of price fluctuations decreases the likelihood of individual windfall gains and increases the attractiveness of investing in securities for risk-averse investors. The individual corporation also bene-

efficient means of compensation.[96] The most commonly-cited economic harms associated with insider trading are that it increases the bid-ask spread set by market makers[97] and that it undermines investor confidence in the markets,[98] both of which increase the cost of capital to firms.[99] There is also the concern that insider trading creates perverse incentives by giving employees an opportunity to profit from their company's bad news.[100]

Starting with issuer-proscribed and misappropriation insider trading, the utility calculus is relatively straightforward. It is fair to assume that neither an issuer (in the case of issuer-proscribed insider trading) nor the source of the information (in the case of misappropriation trading) would demand a commitment from the would-be trader not to trade unless they expected an all-things-considered net harm would result from such trading. If insiders or misappropriators were permitted to trade despite their commitment not to do so, then issuers and sources would be forced to incur these costs. Add to this the broader disutility of undermining the socially beneficial practice of promise-making in the corporate context,[101] as well as the general market costs associated with a higher bid-ask spread, moral

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fits from accurate pricing of its securities through reduced investor uncertainty and improved monitoring of management's effectiveness." Stephen Bainbridge, *Insider Trading: An Overview*, ENCYCLOPEDIA OF LAW AND ECONOMICS 777-78 (Boudewijn Boukaert and Gerrit De Gees eds., 2000). *See also*, MANNE, *supra* note 1, at 80-90.

96 Insider trading can serve as an attractive form of compensation for company employees that encourages innovation and entrepreneurship at relatively little cost to the shareholders. *See, e.g.*, Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, 14 Q. J. AUSTRIAN ECON. 3, 17-18 (2011). As Manne explains, if a "service performed is or can be one which gives access to valuable information [that can be monetized], less of other forms of compensation must be paid in order to secure the same amount of the service." Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 579 (1970).

97 Where insider trading is unchecked by regulation, there is the concern that market makers will be forced to increase the spread between their bid and ask prices to protect against adverse selection by insiders. *See, e.g.*, Harold Demsetz, *Perfect Competition, Regulation, and the Stock Market*, ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, 14 (Henry G. Manne ed., 1969). 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." Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 98 (2004).

98 *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("Although informational disparity is inevitable in securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").

99 *See, e.g.*, Dolgopolov, *supra* note 97, 100-01 ("a greater bid-ask spread is likely to have an adverse effect on the security's liquidity, the firm's cost of capital, and its stock price").

100 *See, e.g.*, Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982).

101 *See* Anderson, *Greed & Envy*, *supra* note 20, at 29.

hazard, and dampened market confidence, and the calculus suggests that these forms of insider trading are morally wrong on utilitarian grounds.[102]

But the landscape changes dramatically once the focus shifts to issuer-licensed insider trading. Here, the issuer's own all-things-considered calculus has determined that such trading will result in a net benefit to the firm. By retaining the power to approve or reject proposed plans, the issuer itself controls the risks. For example, it must be presumed that when an issuer licenses a trade its calculus has already factored in any potential increases in cost of capital and decreased share liquidity that might result from an increased bid-ask spread. Retaining the discretion to approve or reject trades in advance also eliminates the risk of perverse employee incentives. Additionally, insofar as issuer-licensed insider trading actually benefits firms (for, again, if it did not, then it would not be licensed), the practice should reinforce rather than undermine market confidence.[103] Finally, any utility calculus must factor the saved costs of enforcement and compliance where such trading is not regulated.[104] In sum, when these considerations are taken together, there can be little doubt that issuer-licensed insider trading is morally permissible on utilitarian grounds.

Ultimately, however, the principal moral objection to issuer-licensed insider trading in our own public political discourse—and therefore the principal obstacle to reform in the U.S.—is not utilitarian. If it were, then the preceding economic considerations would probably be enough to win the public's hearts and minds over for liberalization. Rather, the principal objection to issuer-licensed insider trading is "consequences be damned, it's just not right!" Such objections are driven by *deontological* moral intuitions sometimes expressed in the mantra, "let justice be done though the heavens fall!"[105]

Deontology is a duty-based moral theory.[106] It does not judge the moral quality of an act by its consequences, but by its motive, and whether that motive complies with the absolute commands of moral law.[107] Perhaps the most recognized articulation of a deontological moral theory is found in the "end-in-oneself" formulation of Immanuel Kant's categorical imperative: "Act so that you treat humanity...always as an end and never as a means

102 *See id.* at 29-30.

103 *See id.* at 41-42.

104 For example, the current regime's U.S. regulation of issuer-licensed insider trading has given rise to the paradox of compliance outlined above in Section III; a regime that permits such trading would resolve this paradox and align the interests of issuers and regulators.

105 *See* 2 ENCYCLOPEDIA OF PHILOSOPHY 343 (Paul Edwards ed., 1967).

106 The word "deontology" finds its root in the Greek word "deon," meaning duty. PETER A. ANGELES, DICTIONARY OF PHILOSOPHY 60 (1981).

107 For a more complete summary of deontological moral theory and its application in this context, *see* Anderson, *Greed & Envy*, *supra* note 20, at 33-43. Much of what follows summarizes arguments first made in *Greed & Envy*.

only."[108] In other words, one should never use another person for purposes that person would reject. Kant's categorical imperative gives expression to our shared commitment to the idea that, as free and equal rational agents, we all enjoy an absolute moral worth that cannot be traded or purchased in the name of private expedience or social welfare. It also offers an explicit theoretical articulation of our common sense notions of justice and fairness. To the extent Manne's student's (and the general public's) objection that insider trading is "just not right" is motivated by such deontological commitments, they draw on deeply rooted and widely shared values. Such objections cannot be answered by talk of pareto efficiencies, and they will not simply go away if dismissed or ignored. They must be explicitly confronted on their own terms if they are to be overcome.

Once again, it is helpful to separate the analysis of issuer-proscribed and misappropriation trading from issuer-licensed insider trading. One need not look beyond the promise the insider makes not to trade on the firm's material nonpublic information to conclude that issuer-*proscribed* insider trading violates Kant's categorical imperative. Such trading necessarily treats the promisee (the firm and its shareholders) solely as the means to an end (the use of the company's material nonpublic information for trading profits) that the promisee has expressly rejected. If an issuer publicly affirms that it does *not* allow its insiders to trade on material nonpublic information, then issuer-proscribed insider trading also treats other traders in that firm's shares as mere means because they have presumably priced its shares based on the expectation that such trading is not permitted. Misappropriation trading is morally impermissible for the same reasons. The misappropriator gains the material nonpublic information on which she trades by making the promise not to trade. In breaking that promise and trading, the misappropriator uses the source of the information as the means to an end the source has expressly rejected.

Things look very different when we turn to issuer-licensed insider trading. Such trading does not deceive or violate a promise to the firm because the firm has licensed the trade. And there is no deception of others who trade in the firm's shares because the issuer has disclosed that it allows its employees to trade based on material nonpublic information and the profits earned by such trading. Such disclosures give counterparties adequate notice and opportunity to price the issuer's shares accordingly. In sum, all interested parties to the issuer-licensed insider's trading (both the issuer, the counterparty, and the broader market) are fully informed in advance of the trade and are therefore respected as ends in themselves and *not* treated as mere means.

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[108] IMMANUEL KANT, FOUNDATIONS OF THE METAPHYSICS OF MORALS 47 (Lewis White Beck trans., 2d ed. 1990) (1785).

These deontological considerations (in addition to others there is no space to develop here[109]) deprive the opponent of legalizing issuer-licensed insider trading of any reason-based justification in terms of fraudulent deception, justice or fairness. And they offer another reason for reform—namely that a whole class of insider trading that incurs criminal liability under our current regime would morally innocent if unregulated. But the moral duties of justice and fairness do not exhaust the ethical landscape. In fact, many journalists, politicians, and judges object to insider trading as a manifestation of the vice of greed. As Professors Charles Cox and Kevin Fogarty put it, "[t]he wave of major insider trading prosecutions has been taken by many as a symptom of cancerous greed on Wall Street."[110] Professor Bainbridge quotes a California state court's claim that insider trading is "a manifestation of undue greed among the already well-to-do, worthy of legislative intervention if for no other reason than to send a message of censure on behalf of the American people."[111] And Manhattan U.S. Attorney Michael Garcia announced that "[g]reed is at work" when the feds unveiled the Galleon Group insider trading case in 2007, celebrating it as "the biggest insider trading bust" since the 1980s.[112] But is policing greed a legitimate end of our criminal justice system? And if it were, would the criminalization of issuer-licensed insider trading be an effective means?

V. GREED IS NOT GOOD, BUT IT SHOULDN'T BE ILLEGAL

"Greed is all right, by the way. I want you to know that. I think greed is healthy. You can be greedy and still feel good about yourself."[113] Ivan Boesky spoke these words in a 1986 commencement address for U.C. Berkeley's Haas School of Business.[114] He would surrender to federal authorities on charges of insider trading and other securities violations just a few short months later.[115] The fictional Gordon Gekko paraphrased Boesky's remarks when he proclaimed that "Greed . . . is good" in Oliver

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109 For a more complete exposition of these arguments, *see* Anderson, *Greed & Envy*, *supra* note 20, at 33-43.

110 Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 353 (1988).

111 STEPHEN M. BAINBRIDGE, RESEARCH HANDBOOK ON INSIDER TRADING 23 (2013) (quoting *Friese v. Super. Ct.*, 36 Cal.Rptr. 3d 558, 566 (Cal. App. 2005)).

112 GASPARINO, *supra* note 21, at 104.

113 *See* STEWARD, *supra* note 47, at 261.

114 *Id.*

115 *Id.* at 265.

Stone's sensational exposé on insider trading, *Wall Street*.[116] Boesky and Gekko are, of course, wrong. Greed is, by definition, not good.[117]

Aristotle explained why greed is a vice—it is the contrary of the virtue of generosity. Generosity is the "mean concerned with the giving and taking of wealth."[118] The generous person is one who will "both give and spend the right amount for the right purposes . . . and do this with pleasure."[119] He does not honor wealth for its own sake, but nevertheless acquires it "for the sake of giving."[120] By contrast, the greedy are "shameful love[rs] of gain" who "go to excess in taking, by taking anything from any source."[121] In their pursuit of wealth for its own sake, they are prepared to go to "great efforts and put up with reproaches."[122]

There is no question that the facts of many insider trading cases reflect the grasping smallness of character Aristotle describes. 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 issuer-licensed insider trading is unjust or unfair. So, if issuer-licensed insider trading is regarded as unethical because it reflects the character flaw of greed—it is a completely self-regarding wrong. In other words, it harms no one but the person who engages in it.

There are at least three points to be made here. First, though issuer-licensed insider trading may sometimes be motivated by greed, it needn't always be so motivated. For example, the generous issuer-licensed insider trader may seek gain to help a family member get through college, to pay for a friend's expensive medical treatment, or to engage in some other form of philanthropy.[123] Thus, any legal prohibition of issuer-licensed insider trading based on greed would be over-inclusive. Moreover, since there are many other opportunities for obscene profit-making in our free-market sys-

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116 WALL STREET (20th Century Fox 1987).

117 The following argument summarizes and in some cases expands on points I first made in *Greed & Envy*, *supra* note 20, at 48-53.

118 ARISTOTLE, THE NICOMACHEAN ETHICS 89 (Terence Irwin trans., 1985) (350 B.C.E).

119 *Id.*

120 *Id.*

121 *Id.* at 92.

122 *Id.* at 93.

123 For example, Rajat Gupta, an ex Goldman Sachs Director who was convicted of insider trading as part of the Galleon Group sting, offered evidence of his extensive philanthropy at the sentencing phase of his trial. *See, e.g.*, 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/?_r=0.

tem (including other ways to profit by trading on material nonpublic information),[124] it would also be woefully under-inclusive.

Second, even if a good argument could be made that allowing issuer-licensed insider trading will tempt citizens to the vice of greed, this is insufficient justification for its criminalization. This justification is paternalistic and moralistic in nature. It would place issuer-licensed insider trading into the same class as now-disfavored moralistic laws against sodomy, adultery, and same-sex marriage. Such laws violate the longstanding tenet of Anglo-American justice and jurisprudence expressed in John Stuart 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.*"[125]

Finally, if we are going to get into the business of criminalizing vicious character traits, perhaps we should scrutinize the motives of the would-be regulators of insider trading. Some have suggested that the criminalization of even issuer-licensed insider trading is best explained as the political exploitation of the vice of envy shared by many in the electorate over the vast disparity in wealth between the hard-working denizens of Main Street and the "fat cats" of Wall Street. As Bainbridge puts it, absent evidence of investor injury, any anger the public feels "over insider trading . . . has nothing to do with a loss of confidence in the integrity of the market, but instead arises principally from envy of the insider's greater access to information."[126] So understood, the prohibition of insider trading "is not so much an antifraud rule as a law against easy money."[127] Professor Donald Langevoort adds that, on this view, which "smacks a bit of populism, of envy and resentment directed at the privileges of class and wealth," insiders "should be content with their paychecks and not overreach for profits."[128]

Envy is generally regarded as one of the worst vices. This is because the perverse goal of envy is the destruction of what is good solely to see another deprived of it.[129] Aristotle describes envy as the perfect vice because it cannot admit of moderation. According to Aristotle, envy's name alone (like "murder") implies badness.[130] And Kant describes it simply as

124 *See* Section II above (noting that, e.g., trading based on material nonpublic information acquired by eavesdropping or luck is not proscribed by the current Section 10(b) insider trading enforcement regime).

125 JOHN STUART MILL, ON LIBERTY 22 (2d ed. 1859) (emphasis added).

126 Bainbridge, *State Law Fiduciary Duties*, *supra* note 21, at 1242.

127 Cox & Fogarty, *supra* note 110, at 360.

128 Donald Langevoort, *Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace*, 16 HASTINGS INT'L & COMP. L. REV. 175, 182 (1993).

129 *See* Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005).

130 ARISTOTLE, *supra* note 118, at 45.

the "hatred of human beings."[131] In addition, the philosopher John Rawls points out that the prevalence of envy in a society can have devastating effects on social stability. 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," 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."[132] Thus, at a minimum, we need to be careful that any criminalization of issuer-licensed insider trading is not motivated by the vice of envy, and is not therefore giving expression to the worst in ourselves and our society.

CONCLUSION

Nothing in this Article is intended as an indictment of the economic analysis of law or its implications for the regulation of insider trading. The work of Manne and others on the economics of insider trading has been absolutely crucial to our understanding of the stakes in play—both financial and moral. I concede that Manne's work constituted the important first step toward insider trading reform. My aim here has been to point out that the economic critique of the U.S. insider trading enforcement regime has gone about as far as it can go. Those who hold the keys to reform continue to answer the economic critique with "it's just not right!" arguments. The result has been an absence of constructive discourse. Parties to the controversy use different vocabularies and therefore continue to speak at cross-purposes. In the meantime, a hopelessly unjust and dysfunctional regime is perpetuated by default. If any change is to occur, the proponents of the current regime must be confronted directly, and with their own ethical vocabulary. Winning the "hearts and minds" of the average American (and therefore the politicians and judges who represent them) is the final step to insider trading reform, and this step can only be made by taking ethical arguments seriously. I have sketched out some of these arguments here, but there is much more to be done.

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131 IMMANUEL KANT, THE METAPHYSICS OF MORALS 206 (Mary Gregor ed. & trans., Cambridge Univ. Press 1996) (1785).

132 JOHN RAWLS, A THEORY OF JUSTICE 532 (1971).